

2023

## Recent Developments in Federal Income Taxation: The Year 2014

Martin J. McMahon Jr.  
*University of Florida Levin College of Law*

Bruce A. McGovern  
*South Texas College of Law*

Ira B. Shepard  
*University of Houston Law Center*

Follow this and additional works at: <https://scholarship.law.ufl.edu/fttr>

---

### Recommended Citation

McMahon, Martin J. Jr.; McGovern, Bruce A.; and Shepard, Ira B. (2023) "Recent Developments in Federal Income Taxation: The Year 2014," *Florida Tax Review*. Vol. 17, Article 3.  
Available at: <https://scholarship.law.ufl.edu/fttr/vol17/iss1/3>

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Tax Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact [jessicaejoseph@law.ufl.edu](mailto:jessicaejoseph@law.ufl.edu).

# FLORIDA TAX REVIEW

Volume 17

2015

Number 3

## RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2014

By  
Martin J. McMahon, Jr.\*  
Bruce A. McGovern\*\*  
Ira B. Shepard\*\*\*

*This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during 2014—and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted—unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least)—income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.*

---

\*James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida College of Law. Daniel L. Simmons, Professor Emeritus of Law, University of California, Davis, Davis, CA, also contributed to this outline. We thank Professor McMahon's research assistants, Lorin Page and Hudson Williams, for proofreading and cite checking this outline.

\*\*Vice President, Associate Dean, and Professor of Law, South Texas College of Law.

\*\*\*Professor Emeritus of Law, University of Houston Law Center.

<b>I.</b>	<b>ACCOUNTING</b> .....	100
	A. Accounting Methods .....	100
	B. Inventories .....	104
	C. Installment Method.....	104
	D. Year of Inclusion or Deduction.....	104
<b>II.</b>	<b>BUSINESS INCOME AND DEDUCTIONS</b> .....	105
	A. Income.....	105
	B. Deductible Expenses versus Capitalization.....	106
	C. Reasonable Compensation .....	112
	D. Miscellaneous Deductions .....	112
	E. Depreciation & Amortization .....	122
	F. Credits.....	132
	G. Natural Resources Deductions & Credits .....	136
	H. Loss Transactions, Bad Debts, and NOLs .....	136
	I. At-Risk and Passive Activity Losses.....	137
<b>III.</b>	<b>INVESTMENT GAIN AND INCOME</b> .....	142
	A. Gains and Losses.....	142
	B. Interest, Dividends, and Other Current Income.....	155
	C. Profit-Seeking Individual Deductions .....	155
	D. Section 121.....	155
	E. Section 1031 .....	155
	F. Section 1033 .....	155
	G. Section 1035.....	156
	H. Miscellaneous.....	156
<b>IV.</b>	<b>COMPENSATION ISSUES</b> .....	156
	A. Fringe Benefits.....	156
	B. Qualified Deferred Compensation Plans .....	162
	C. Nonqualified Deferred Compensation, Section 83, and Stock Options .....	165
	D. Individual Retirement Accounts .....	166
<b>V.</b>	<b>PERSONAL INCOME AND DEDUCTIONS</b> .....	174
	A. Rates.....	174
	B. Miscellaneous Income.....	180
	C. Hobby Losses and § 280A Home Office and Vacation Homes	186
	D. Deductions and Credits for Personal Expenses.....	188
	E. Divorce Tax Issues .....	195
	F. Education .....	197
	G. Alternative Minimum Tax .....	197
<b>VI.</b>	<b>CORPORATIONS</b> .....	197
	A. Entity and Formation .....	197
	B. Distributions and Redemptions .....	197
	C. Liquidations.....	201

	D. S Corporations.....	201
	E. Mergers, Acquisitions, and Reorganizations .....	204
	F. Corporate Divisions .....	208
	G. Affiliated Corporations and Consolidated Returns .....	208
	H. Miscellaneous Corporate Issues .....	210
<b>VII.</b>	<b>PARTNERSHIPS</b> .....	211
	A. Formation and Taxable Years .....	211
	B. Allocations of Distributive Share, Partnership Debt, and Outside Basis.....	217
	C. Distributions and Transactions Between the Partnership and Partners .....	221
	D. Sales of Partnership Interests, Liquidations, and Mergers .....	227
	E. Inside Basis Adjustments .....	229
	F. Partnership Audit Rules .....	231
	G. Miscellaneous.....	238
<b>VIII.</b>	<b>TAX SHELTERS</b> .....	238
	A. Tax Shelter Cases and Rulings.....	238
	B. Identified “Tax Avoidance Transactions” .....	258
	C. Disclosure and Settlement .....	258
	D. Tax Shelter Penalties.....	258
<b>IX.</b>	<b>EXEMPT ORGANIZATIONS AND CHARITABLE GIVING</b> .....	269
	A. Exempt Organizations .....	269
	B. Charitable Giving .....	273
<b>X.</b>	<b>TAX PROCEDURE</b> .....	292
	A. Interest, Penalties, and Prosecutions .....	292
	B. Discovery: Summonses and FOIA .....	297
	C. Litigation Costs .....	310
	D. Statutory Notice of Deficiency.....	313
	E. Statute of Limitations .....	313
	F. Liens and Collections .....	313
	G. Innocent Spouse .....	321
	H. Miscellaneous.....	321
<b>XI.</b>	<b>WITHHOLDING AND EXCISE TAXES</b> .....	334
	A. Employment Taxes .....	334
	B. Self-Employment Taxes.....	339
	C. Excise Taxes.....	341
<b>XII.</b>	<b>TAX LEGISLATION</b> .....	346
	A. Enacted.....	346

The **Tax Increase Prevention Act of 2014**, Pub. L. No. 113-295, colloquially called the “Extenders Bill,” was signed by the President on 12/19/14. The Tax Increase Prevention Act [hereinafter TIPA] retroactively extended through 12/31/14 a myriad of deductions, credits, and special benefit provisions that had expired at the end of 2013. It did not address extension of these provisions, or any other expired provisions, to 2015. This outline mentions some of the more important provisions that were extended, but does not attempt comprehensively to list the extenders or to explain them in detail. TIPA also made miscellaneous technical corrections, none of which are discussed herein, and encompassed The Achieving a Better Life Experience (ABLE) Act of 2014.

## I. ACCOUNTING

### A. Accounting Methods

1. **The Tax Court sides with the taxpayer on application of the completed contract method of accounting to development of planned residential communities.** Shea Homes, Inc. v. Commissioner, 142 T.C. 60 (2/12/14). The taxpayer was a home builder using the completed contract method allowed by § 460(e) (which provides an exception to the percentage-of-completion method otherwise required); the taxpayer developed large, planned residential communities. The question was whether the subject matter of the contracts consisted only of the houses and the lots on which the houses were built, as argued by the IRS, or the homes and the larger development, including amenities and other common improvements, as argued by the taxpayer. The contracts were home construction contracts under § 460(e)(6) because Reg. § 1.460-3(b)(2)(iii) provides that the cost of the dwelling units includes “their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.” More specifically, the taxpayer’s position was that the contracts were completed when they met the test under Reg. § 1.460-1(c)(3)(i)(A) that the property was used by the customer for its intended purpose and 95 percent of the costs of the development had been incurred. Under this argument, final completion and acceptance pursuant to Reg. § 1.460-1(c)(3)(B) did not occur (excluding secondary items, if any, pursuant to Reg. § 1.460-1(c)(3)(B)(ii)) until the last road was paved and the final bond was released. The Tax Court (Judge Wherry) upheld the taxpayer’s position. Judge Wherry rejected the IRS’s argument that the common improvements were “secondary items.” A key

element in the holding was that the taxpayer was required by the contracts and by state law to complete common improvements, and that the obligation was secured by “hefty performance bonds.”

• The decision might be narrower than it appears on its face. Footnote 24 of the opinion states as follows:

We are cognizant that our Opinion today could lead taxpayers to believe that large developments may qualify for extremely long, almost unlimited deferral periods. We would caution those taxpayers a determination of the subject matter of the contract is based on all the facts and circumstances. If Vistancia, for example, attempted to apply the contract completion tests by looking at all contemplated phases, it is unlikely that the subject matter as contemplated by the contracting parties could be stretched that far. Further, sec. 1.460-1(c)(3)(iv)(A), Income Tax Regs., may prohibit taxpayers from inserting language in their contracts that would unreasonably delay completion until such a super development is completed.

**a. Howard Hughes may have died nearly 40 years ago, but his successors are still trying to fly the Spruce Goose.** Howard Hughes Co., LLC v. Commissioner, 142 T.C. No. 20 (6/2/14). The taxpayer was in the residential land development business. The taxpayer generally sold land through bulk sales, pad sales, finished lot sales, and custom lot sales. In bulk sales, it developed raw land into villages and sold an entire village to a builder. In pad sales, it developed villages into parcels and sold the parcels to builders. In finished lot sales, it developed parcels into lots and sold whole parcels of finished lots to builders. In custom lot sales, it sold individual lots to individual purchasers or custom home builders, who then constructed homes. The taxpayer never constructed any residential dwelling units on the land it sold. The taxpayer reported income from purchase and sale agreements under the § 460 completed contract method of accounting—generally when it had incurred 95 percent of the estimated costs allocable to each sales agreement. The IRS took the position that the land sales contracts were not home construction contracts within the meaning of § 460(e) and that the bulk sale and custom lot contracts were not long-term construction contracts eligible for the percentage of completion method of accounting under § 460. (The IRS conceded that the other contracts were long-term construction contracts.) The Tax Court (Judge Wherry) held that the bulk sale and custom lot contracts were long-term construction contracts under § 460(f)(1), and that the taxpayer could report gain or loss from those contracts on the appropriate long-term method of accounting to the extent it had not completed the

contracts within a year of entering into them. The contracts included more than just the sale of lots. The costs incurred for a custom lot contract are not really different from the costs for the finished lot sales. The contracts included development of things such as water service, traffic signals, landscaping, and construction of parks, which did not necessarily occur prior to the closing. Completion of the contracts thus occurred upon final completion and acceptance of the improvements, the cost of which was allocable to the custom lot contracts. However, none of the contracts qualified as home construction contracts eligible for the completed contract reporting method under § 460(e). In relevant part, § 460(e)(6) defines a home construction contract as follows:

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

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

Our Opinion today draws a bright line. A taxpayer’s contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of

such dwelling units. It is not enough for the taxpayer to merely pave the road leading to the home, though that may be necessary to the ultimate sale and use of a home. If we allow taxpayers who have construction costs that merely benefit a home that may or may not be built, to use the completed contract method of accounting, then there is no telling how attenuated the costs may be and how long deferral of income may last.

**2. It turns out that 6666, not 666, is the mark of the devil for the IRS.** Burnett Ranches, Ltd. v. United States, 753 F.3d 143 (5th Cir. 5/22/14). Burnett Ranches operated two cattle and horse breeding operations and reported on the cash method. The principal owner, beneficial owner, and the manager of Burnett Ranches, Anne Burnett Windfohr Marion, interposed an S corporation between herself and one of the two major ranch properties (6666, the Four Sixes) and had a direct interest in, and was a beneficiary of, a trust that held an interest in the other major ranch property (Dixon Creek). The IRS took the position that Burnett Ranches was a “farming syndicate” required by § 464 to use the accrual method of accounting. Speaking generally, § 464 requires farming partnerships to use the accrual method if either (1) they are syndicated or (2) more than 35 percent of losses are attributable to limited partners. But because it is targeted at late twentieth century tax shelters, it has a number of exceptions that cover “family farms.” The taxpayer maintained that the exception in § 464(c)(2)(A) for active management by an individual holding an interest (even if as a limited partner) applied. The government conceded that (1) Ms. Marion did “actively participate” in the management of Burnett Ranches’ agricultural business for not less than five years previously, and (2) her interest in Burnett Ranches was “attributable to” her active participation, but argued that the interposition of the S corporation between the entity owning the ranch and Ms. Marion rendered the exception inapplicable. The District Court granted judgment in favor of the taxpayer, and, in an opinion by Judge Wiener, the Fifth Circuit affirmed. The court rejected the government’s argument that the interest of the individual actively managing the farm or ranch had to be held by direct legal title for the exception to apply, focusing on the language of § 464(c)(2)(A), which describes the excepted interest as “in the case of any individual who has actively participated (for a period of not less than five years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation.” The court reasoned that by using the language “interest . . . attributable to such active participation,” “Congress did not restrict sub-subsection (A)’s particular

exception to interests of which such an actively participating manager holds legal title in his or her name.”

## **B. Inventories**

There were no significant developments regarding this topic during 2014.

## **C. Installment Method**

**1. Beginning to updating regulations only thirty-four years after the Code section number was changed.** REG-109187-11, Nonrecognition of Gain or Loss on Certain Dispositions of Installment Obligations, 79 F.R. 76928 (12/23/14). The Treasury Department and IRS have published proposed amendments to Regs. §§ 1.351-1(a), 1.361-1, 1.453B-1, and 1.721-1(a) to provide that a transferor does not recognize gain under § 453B or otherwise (or loss) on the transfer of an installment obligation if gain or loss is not recognized on the disposition under any of §§ 351, 361, or 721. However, the proposed regulations provide that this general rule does not apply to the satisfaction of an installment obligation. For example, an installment obligation of an issuer, such as a corporation or partnership, is satisfied when the holder transfers the obligation to the issuer for an equity interest in the issuer. These proposed amendments reflect the replacement in 1980 of former § 453(d) with § 453B, and the proposed amendments replace current Reg. § 1.452-9(c)(2), issued under former § 453(d). With respect to a satisfaction transfer, the proposed regulations incorporate the holding of Rev. Rul. 73-423, 1973-2 C.B. 161, which held that in such a case involving a corporation as the obligor, the transferor recognizes gain or loss on the satisfaction of the obligation to the extent of the difference between the transferor’s basis in the obligation and the fair market value of the stock received, even though gain or loss generally is not recognized on § 351 transfers.

- The proposed amendments will be effective upon publication of final amended regulations.

## **D. Year of Inclusion or Deduction**

**1. This Eagle’s wings got clipped.** Giant Eagle, Inc. v. Commissioner, T.C. Memo. 2014-146 (7/23/14). The taxpayer owned and operated supermarkets and gas stations. It offered a customer loyalty program by which customers making qualifying purchases at the supermarket could earn “fuelperks!” that were redeemable for a discount against the purchase

price of gas at the gas stations. The taxpayer, which used the accrual method, claimed deductions for certain unredeemed fuelperks! for the years at issue. The Tax Court (Judge Haines) disallowed the deductions because the “all events” test of § 461 had not been satisfied. The redemption of fuelperks! was structured as a discount against the purchase price of gas, and the purchase of gas was necessarily a condition precedent to the redemption of fuelperks! The court declined to analogize the fuelperks! to trading stamps or premium coupons “redeemable in merchandise, cash, or other property” issued by a retailer, which under Reg. § 1.451-4(a)(1) can offset income in the year issued, applying instead Rev. Rul. 78-212, 1978-1 C.B. 139, in which the IRS ruled that a taxpayer using the accrual method of accounting who and with the sale of products issued coupons that could be redeemed for a discount on the sale prices of products purchased in the future could not apply Reg. § 1.451-4(a)(1); those coupons were not “redeemable in merchandise, cash, or other property” because the redemption of the coupons was conditioned on an additional purchase of the retailer’s product by the consumer.

## II. BUSINESS INCOME AND DEDUCTIONS

### A. Income

**1. The IRS says that for some purposes pledging ownership of a disregarded LLC is the same thing as mortgaging the LLC’s real property.** Rev. Proc. 2014-20, 2014-9 I.R.B. 614 (2/5/14). This revenue procedure provides a safe harbor under which the IRS will treat indebtedness that is secured by 100 percent of the ownership interest in a disregarded entity holding real property as indebtedness that is secured by real property for purposes of § 108(c)(3)(A). Section 108(a)(1)(D) allows noncorporate taxpayers to elect to exclude income arising from cancellation of “qualified real property business indebtedness.” Section 108(c)(3)(A) defines qualified real property business indebtedness as indebtedness incurred in connection with, and secured by, real property used in a trade or business. The exclusion is limited to the amount by which qualified real property business indebtedness exceeds the fair market value of property secured by the debt, which limits the exclusion under § 108(a)(1)(D) to so-called “phantom gain.” Section 108(c)(2)(B) further limits the amount of the exclusion to the aggregate adjusted basis of depreciable real property held by the taxpayer immediately before the cancellation. “Qualified real property business indebtedness” includes only (1) debt incurred or assumed by the taxpayer before 1993 “in connection with” real property used by the taxpayer in a trade or business and secured by the real property, and (2) debt incurred or assumed after 1992 to acquire, construct, reconstruct, or substantially improve the property secured by the debt or to refinance qualifying pre-1993 indebtedness

to the extent the refinancing does not exceed the original debt. This revenue procedure provides that as long as the indebtedness meets the other requirements of § 108(c)(3), the IRS will treat such indebtedness as secured by real property for purposes of § 108(c)(3)(A), and thus as “qualified real property business indebtedness,” eligible for exclusion from gross income pursuant to § 108(a)(1)(D), subject to the limitations provided in § 108(c), any indebtedness that meets the following conditions: (1) the taxpayer or a wholly owned disregarded entity of the taxpayer incurs indebtedness, (2) the taxpayer borrower directly or indirectly owns 100 percent of the ownership interest in a disregarded entity owning real property, (3) the taxpayer borrower pledges to the lender a first priority security interest in the borrower’s ownership interest in the disregarded entity; any further encumbrance on the pledged ownership interest must be subordinate to the lender’s security interest, (4) at least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by the disregarded entity must be real property used in a trade or business, and any other assets held by the disregarded entity must be incidental to the entity’s acquisition, ownership, and operation of the real property, and (5) upon default and foreclosure on the indebtedness, the lender will replace the borrower as the sole member of the disregarded entity owning the property.

## B. Deductible Expenses versus Capitalization

1. **Those fancy Pyrex® and Oneida® branded kitchen products are made by Robinson Knife Manufacturing, which is required to capitalize license fees.** Robinson Knife Manufacturing Co. v. Commissioner, T.C. Memo. 2009-9 (1/14/09). The taxpayer designs and produces kitchen tools for sale to large retail chains. To enhance its marketing, the taxpayer paid license fees to Corning for use of the Pyrex trademark and Oneida for use of the Oneida trademark on kitchen tools designed and produced by the taxpayer. The taxpayer’s production of kitchen tools bearing the licensed trademarks was subject to review and quality control by Corning or Oneida. The IRS asserted that the taxpayer’s licensing fees were subject to capitalization into inventory under § 263A under Reg. § 1.263A-1(e)(3)(ii)(Uu), which expressly includes licensing and franchise fees as indirect costs that must be allocated to produced property. Agreeing with the IRS, the court (Judge Marvel) rejected the taxpayer’s argument that the licensing fees, incurred to enhance the marketability of its produced products, were deductible as marketing, selling, or advertising costs excluded from the capitalization requirements by Reg. § 1.263A-1(e)(3)(iii)(A). The court noted that the design approval and quality control elements of the licensing agreements benefited the taxpayer in the development and production of

kitchen tools marketed with the licensed trademarks. The court rejected the taxpayer's argument that Rev. Rul. 2000-4, 2000-1 C.B. 331, which allowed a current deduction for costs incurred in obtaining ISO 9000 certification as an assurance of quality processes in providing goods and services, was applicable to the quality control element of the license agreements. The court noted that although the trademarks permitted the taxpayer to produce kitchen tools that were more marketable than the taxpayer's other products, the royalties directly benefited or were incurred, or both, by reason of the taxpayer's production activities. The court also upheld the IRS's application of the simplified production method of Reg. § 1.263A-2(b) to allocate the license fees between cost of goods sold and ending inventory as consistent with the taxpayer's use of the simplified production method for allocating other indirect costs.

**a. But the Second Circuit disagrees.**

Robinson Knife Manufacturing Co. v. Commissioner, 600 F.3d 121 (2d Cir. 3/19/10). Like the Tax Court, the Court of Appeals rejected Robinson's arguments that the royalty payments were deductible as marketing, selling, advertising, or distribution costs under Reg. § 1.263-1(e)(3)(iii)(A), or that the royalty payments were deductible as not having been incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced under Reg. § 1.263A-1(e)(3)(ii)(U). The Court of Appeals concluded, however, that "royalty payments which are (1) calculated as a percentage of sales revenue from certain inventory, and (2) incurred only upon sale of such inventory, are not required to be capitalized under the § 263A regulations." The court held that the royalties were neither incurred in, nor directly benefited, the performance of production activities under Reg. § 1.263A-1(e)(3)(i). Unlike license agreements, the court concluded that Robinson could have manufactured the products, and did, without paying the royalty costs. The royalties were not, therefore, incurred by reason of the production process. The court also concluded that since the royalties were incurred for kitchen tools that have been sold, "it is necessarily true that the royalty costs and the income from sale of the inventory items are incurred simultaneously." The court noted further that had Robinson's licensing agreements provided for non-sales based royalties, then capitalization would have been required.

**b. Proposed regulations make you wonder why the IRS ever litigated *Robinson Knife*.** REG-149335-08, Sales-Based Royalties and Vendor Allowances, 75 F.R. 78940 (12/17/10). The IRS has proposed regulations under § 263A that generally provide the taxpayer-favorable result reached by the Second Circuit in *Robinson Knife*. The proposed regulations provide that sales-based royalties must be capitalized,

but also provide that sales-based royalties required to be capitalized are allocable only to property that a taxpayer has sold, rather to closing inventory. The preamble asserts that the Second Circuit in *Robinson Knife* misconstrued the nature of costs required to be capitalized and that the costs of securing rights to use intellectual property directly benefits, or are incurred by reason of, production processes requiring that the costs be capitalized even if payable only on the basis of the number of units sold or as a percentage of revenue. Nonetheless, the proposed regulations are consistent with the holding of *Robinson Knife* where they provide that sales-based royalties are related only to units that are sold during the taxable year. Thus, Prop. Reg. § 1.263A-3(d)(3)(i)(C)(3) would provide that sales-based costs would not be included in ending inventory under § 471.

- However, in light of the generous treatment of sales-based royalties, the proposed § 263A regulations, along with proposed amendments to Reg. § 1.471-3(e), require that sales-based vendor allowances (which are rebates or discounts from a vendor as a result of selling the vendor's merchandise) must be taken into account as an adjustment to the cost of merchandise sold, effectively requiring that such allowances be included in gross income immediately, and would not be taken into account in ending inventory.

- The formulas allocating additional indirect costs to ending inventory under the simplified production and resale methods would be modified to remove capitalized sales-based royalties and vendor allowances allocable to property that has been sold.

**c. But the IRS still disagrees with the Second Circuit.** AOD 2011-01, 2011-9 I.R.B. 526 (2/8/11), *corrected by* Ann. 2011-32, 2011-22 I.R.B. 836 (5/31/11). The IRS disagrees with the Second Circuit analysis stating that the court “confused the timing with the purpose of the payments.” The IRS opines that Robinson incurred the royalty expenses first to produce then to sell the trademarked items, adding that in order to sell the items it first had to produce them.

**d. Final Sales-Based Royalty and Vendor Allowance regulations.** T.D. 9652, Sales-Based Royalties and Vendor Allowances, 79 F.R. 2094 (1/13/14). The final regulations follow the proposed regulations on sales-based royalties with the modification of permitting taxpayers to either (1) allocate sales-based royalties entirely to property sold, or (2) to allocate these royalties between cost of goods sold and ending inventory using either (a) a facts-and-circumstances cost allocation method, (b) the simplified production method, or (c) the simplified resale method. Sales-based vendor chargebacks will still reduce cost of goods sold (as in the

proposed regulations) but the treatment of sales-based vendor allowances other than chargebacks is reserved in the final regulations.

**e. And detailed procedures for changing methods of accounting based on the above final regulations.** Rev. Proc. 2014-33, 2014-22 I.R.B. 1060 (5/6/14), *modifying* Rev. Proc. 2011-14, 2011-2 C.B. 330. This revenue procedure provides the exclusive procedures by which a taxpayer obtains consent under § 446(e) to (1) change its method of accounting for royalties, (2) change its method of accounting for sales-based vendor chargebacks, or (3) change its simplified production method or simplified resale method for costs allocated only to inventory property that has been sold, to comply with the T.D. 9652 final regulations. The detailed procedures are contained in new section 11.11 of the APPENDIX to Rev. Proc. 2011-14.

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

**3. Protecting directors from cement shoes in a shareholder class-action arising from a merger subject to capitalization. Why apply modern regulations when old case law will do the trick? Ash Grove Cement Co. v. United States, 111 A.F.T.R.2d 2013-767 (D. Kan. 2/6/13).** The taxpayer settled a class action lawsuit by minority shareholders against itself and its directors arising out of the acquisition of another corporation in a reorganization. The District Court (Judge Murguia) granted summary judgment for the government, holding that both the settlement payment and litigation expenses incurred by the taxpayer in resolving the class action lawsuit were capital expenditures under § 263. The origin of the claim for which the taxpayer incurred the expenses arose from a capital transaction. Even though the payments related to the taxpayer's 2005 return, the court applied the case law based "origin of the claim" test, *e.g.*, *Woodward v. Commissioner*, 397 U.S. 572 (1970), rather than Reg. § 1.263(a)-5, which was promulgated in 2003. The court held that the litigation expenses arose out of the acquisition transactions and were thus capital expenses under the origin of

the claim test. The court rejected the taxpayer's argument that expenses incurred to indemnify directors from legal claims were deductible. The court pointed out that under the taxpayer's approach, "companies could always deduct litigation expenses any time a director acting in good faith is sued in connection with a capital transaction so long as the company has an indemnity obligation."

**a. Affirmed on the same case law grounds.**

Ash Grove Cement Co. v. United States, 562 F. App'x 697 (10th Cir. 4/22/14), *aff'g* 111 A.F.T.R.2d 2013-767 (D. Kan. 2/6/13). The Tenth Circuit (Judge Lucero) affirmed on the ground that "[c]ourts have repeatedly concluded that litigation costs arising out of corporate reorganizations are capital expenditures." He refused to distinguish the *Woodward* line of cases on the grounds that the litigation here "did not involve the purchase of a capital asset or setting the price of a capital asset" by noting that the litigation concerned the purchase price for the acquisition of another corporation in the reorganization and the settlement payment was a capital expense. As to the deductibility of the legal expenses, he concluded that the "Supreme Court has previously determined that a variation in state law that changed the relationship between parties involved in a suit regarding capital expenses did not alter the deductibility of expenditures," citing *United States v. Hilton Hotels Corp.*, 397 U.S. 580, 583-84 (1970).

**4. What is "insurance"?** Rev. Rul. 2014-15, 2014-24 I.R.B. 1095 (5/8/14). This revenue ruling provides that a particularly described arrangement under which an employer funds retiree health benefits through a wholly owned subsidiary is insurance for federal income tax purposes. The subsidiary is an insurance company under Subchapter L.

**5. In the Sixth Circuit, even if not necessarily in the rest of the country, lease termination expenses are deductible and not capitalized into the basis of an acquired building.** ABC Beverage Corp. v. United States, 756 F.3d 438 (6th Cir. 6/13/14), *aff'g* 577 F. Supp. 2d 935 (W.D. Mich. 8/27/08). The taxpayer operated a bottling facility in a leased building. Because it considered the rent to be excessive, it exercised an option to purchase the property. Appraisals valued the property without the lease at \$2.75 million, but the taxpayer determined that the fair market value of the property with the lease would be at least \$9 million and it eventually bought the property for more than \$9 million. The taxpayer treated \$2.75 million as its cost of acquiring the property and deducted \$6.25 million as a business expense for terminating the lease. Applying *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948), the Sixth Circuit, in an opinion

by Judge Cole, upheld the deduction, rejecting the government's argument that the Supreme Court's subsequent decisions in *Woodward v. Commissioner*, 397 U.S. 572 (1970), *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), and *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), had overruled *Cleveland Allerton Hotel, Inc.* Further, the court held that § 167(c)(2), which was enacted after *Cleveland Allerton Hotel, Inc.* was decided, did not apply. Section 167(c)(2) provides that "[i]f any property is acquired subject to a lease," the taxpayer is prohibited from allocating any part of the property's cost to the leasehold interest and is required to capitalize the entire cost of the property. The court concluded that "the phrase 'acquired subject to a lease' is best understood to encompass only those acquisitions in which the lease continues after the purchase." In so doing, the Sixth Circuit acknowledged that in *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (1993), the Tax Court had reached the opposite conclusion regarding the ambit of § 167(c)(2), but disagreed with the Tax Court's conclusion.

**6. Research to eliminate uncertainty is deductible under final regulations. What about the uncertainty of tax advice?** T.D. 9680, Research Expenditures, 79 F.R. 42193 (7/21/14). The Treasury Department has finalized, with minor revisions, amendments to Reg. § 1.174-2 proposed in REG-124148-05, Research Expenditures, 78 F.R. 54796 (9/6/13). Section 174 allows either deduction or 60 month amortization of research and experimental expenditures, but under § 174(c) the § 174 deduction is not applicable to expenditures for the acquisition or improvement of land or depreciable property. Reg. § 1.174-2(a)(1) defines research and experimental expenditures as expenditures that represent "research and development costs in the experimental or laboratory sense" and provide in § 1.174-2(b)(1) that depreciation allowances on depreciable property used in research are § 174 expenditures. The final regulations provide that expenditures may qualify under § 174 regardless of whether a resulting product is sold or used in the taxpayer's trade or business and that the depreciable property rule is an application of the general definition of research and experimental expenditures.

- Reg. § 1.174-2(a)(1) provides that the ultimate success, failure, sale, or use of a product is not relevant to a determination of eligibility of expenditures as research or experimental expenditures under § 174.

- Reg. § 1.174-2(b)(4), as interpreted by the preamble to the proposed and final regulations, makes clear that, as an application of the general definition of research expenditures, the depreciable property rule should not be applied to exclude otherwise eligible expenditures.

- Under Reg. § 1.174-(a)(2), research expenditures to develop a product include development of a pilot model. Reg.

§ 1.174-2(a)(4) defines a pilot model as “any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product.”

- The regulations amend Reg. § 1.174-2(a)(1) to “clarify” that production costs after uncertainty is eliminated are not eligible under § 174 by providing that “[c]osts may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.”

- Reg. § 1.174-2(a)(5) adopts a “shrinking back rule” that provides that research and experimental expenditures for the improvement of a component of a larger design may be eligible under § 174, but uncertainty with respect to components does not necessarily indicate uncertainty with respect to the product as a whole.

- The amendments to Reg. § 1.174-2 apply to tax years ending on or after 7/21/14, but taxpayers can apply these amendments to tax years for which the period of limitations on assessment of tax has not expired.

### C. Reasonable Compensation

1. **A circular cash flow is not respected, particularly where there are insufficient funds in the bank to back up the rubber check.** Vaney Associates, Inc. v. Commissioner, T.C. Memo. 2014-184 (9/11/14). The Tax Court (Judge Buch) upheld the disallowance of deductions for a cash method corporation that paid its sole shareholder employee a year-end bonus (on Dec. 30) by a check that the corporation did not have sufficient funds to honor and which was immediately endorsed back to the corporation as a loan.

### D. Miscellaneous Deductions

1. **A partner’s unreimbursed reimbursable expenses incurred on behalf of the partnership are not deductible on his own return.** McLauchlan v. Commissioner, T.C. Memo. 2011-289 (12/19/11). The taxpayer was a partner in a law firm and he paid various expenses, such as advertising, home office, automobile, travel, meals, entertainment, cell phone, professional organizations, continuing legal education, state bar membership, supplies, interest, banking fees, and legal support services in connection with his law practice. The partnership reimbursed him for over \$60,000 of the expenses in each year in question, but he claimed more than \$100,000 of additional expense on Schedule C in each year. The Tax Court (Judge Kroupa) articulated the principal issue as whether a partner can deduct unreimbursed expenses incurred in furtherance of the partnership’s business. She then

articulated the relevant legal principle as prohibiting a partner from deducting on his own return expenses of the partnership, even if the expenses were incurred by the partner in furtherance of partnership business, unless there is an agreement among partners, or a routine practice equal to an agreement, that requires a partner to use his or her own funds to pay a partnership expense, citing *Cropland Chem. Corp. v. Commissioner*, 75 T.C. 288, 295 (1980), *aff'd without published opinion*, 665 F.2d 1050 (7th Cir. 1981). In the instant case, the partnership agreement required petitioner to pay “indirect partnership expenses” that were unreimbursable, but there was no routine practice that required petitioner to pay any other partnership expenses. Thus, expenses at issue were deductible only if they were unreimbursable indirect partnership expenses that were actually incurred. Turning to the facts, Judge Kroupa found that all of the claimed expenses were either reimbursable under the partnership agreement or not properly substantiated. Accordingly, all of the claimed deductions were disallowed and § 6662 accuracy related penalties were upheld.

**a. And it appears to be black letter law to the Fifth Circuit.** *McLauchlan v. Commissioner*, 558 F. App'x 374 (5th Cir. 3/6/14)). The Fifth Circuit, in a per curiam opinion, affirmed the Tax Court. First, the court restated what it considered to be the black letter law:

Generally, a partner may not deduct the expenses of the partnership on his individual return, even if the expenses were incurred by the partner in furtherance of partnership business. *Cropland Chem. Corp. v. Comm'r*, 75 T.C. 288, 295 (1980), *aff'd.*, 665 F.2d 1050 (7th Cir. 1981) (unpublished table decision). The exception to this rule is where “under a partnership agreement, a partner has been required to pay certain partnership expenses out of his own funds, he is entitled to deduct the amount thereof from his individual gross income.” *Klein v. Comm'r*, 25 T.C. 1045, 1052 acq., 1956-2 C.B. 4 (1956).

In light of this law, the Court of Appeals found that the Tax Court record did not establish that the partnership had a routine practice requiring partners to pay any of its expenses outside the terms of the partnership agreement. Accordingly, “expenses McLauchlan claimed as deductions beyond those identified in the partnership agreement, such as for advertising, contract labor, home insurance, interest, office supplies, utilities, and wages, were expenses McLauchlan chose to incur, rather than ones called for by AR’s partnership agreement. They therefore were not deductible on McLauchlan’s individual tax return.” Presumably, the court found these expenses not to have been

“necessary” in the strictest sense of the word. Next, the Court of Appeals concluded that the expenses McLauchlan was required by the partnership agreement to incur, except automobile expenses, were reimbursable by the partnership, but McLauchlan failed to seek reimbursement. The court cited *Occhipinti v. Commissioner*, T.C. Memo. 1969-190, *aff’d sub nom. Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971), for the proposition that if a partner has a right to reimbursement and does not pursue it, the partner is not entitled to deduct the expenses. Thus, he was “not required to pay, without reimbursement, any of the claimed expenses at issue and thus they were not properly deductible as unreimbursed partnership expenses.”

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

**a. Affirmed by the Fifth Circuit.** *Salty Brine I, Ltd. v. United States*, 761 F.3d 484 (5th Cir. 7/31/14). The Fifth Circuit (Judge Davis) affirmed the district court, finding that the arrangement was an invalid attempt to assign income, so the alleged insurance premiums were not deductible. He also found that the arrangement lacked economic substance, based on it failing the first of the three factors of the “multi-factor test for when a transaction must be honored as legitimate for tax purposes.” This test requires that the transaction satisfy all three of the following factors; i.e., if it: “(1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features.”

**3. A judge lets the jury decide how much of \$126,796,262 of a \$385,147,334 settlement payment under the False Claims Act is compensatory and how much is a nondeductible penalty.** *Fresenius Medical Care Holdings, Inc. v. United States*, 111 A.F.T.R.2d 2013-1938 (D. Mass. 5/9/13). The taxpayer deducted the full amount of a \$385,147,334 settlement with the government under the False Claims Act (for Medicare and Medicaid fraud), which provides for a penalty of not less than

\$5,000 and not more than \$10,000 plus three times the amount of damages the government sustains. The settlement agreement was silent regarding the allocation of the payment between compensatory and punitive amounts, although it did allocate \$65,800,555 to *qui tam* relators' awards. The agreement expressly disclaimed any resolution of the tax treatment of the payment. The IRS allowed a portion of the deduction but disallowed as a fine or similar penalty, which is nondeductible under § 162(f), \$126,796,262 of the claimed deduction. The District Court denied cross motions for summary judgment because "real disputes remained about the purpose of the payments," and on a motion for entry of judgment held that the jury properly determined that \$95,000,000 of the disputed amount of the settlement paid to the government was compensatory and therefore deductible. The court explained that "a manifest agreement is not necessary for [the taxpayer] to establish that all or some portion of the payments at issue were made in settlement of non-punitive FCA liability." It concluded that "to determine whether the payments made by [the taxpayer] to the government in excess of the amount already deemed deductible by the IRS were compensatory damages, it was necessary to consider both the language of the settlement agreements and non-contractual evidence regarding the purpose and application of the payments."

**a. And the First Circuit says to the government 🎵🎵"that's ok, that's alright, I'm gonna do something you don't like."🎵🎵 Fresenius Medical Care Holdings, Inc. v. United States, 763 F.3d 64 (1st Cir. 8/13/14).** In an opinion by Judge Selya, the First Circuit affirmed the District Court's judgment. The Court of Appeals rejected the government's argument that "the absence of an agreement between the parties as to whether the payments will be deductible defeats Fresenius's claim of deductibility," characterizing the government's argument as "assign[ing] talismanic significance to the presence or absence of a tax characterization agreement between the settling parties." Rather, the court held that in determining the tax treatment of a False Claims Act civil settlement, a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the government and the settling party. The court reasoned as follows:

The government's proposed rule is also in serious tension with yet another fundamental tenet of tax law. This tenet holds that amounts paid or received in settlement should receive the same tax treatment, to the extent practicable, as would have applied had the dispute been litigated and reduced to judgment. *See, e.g., Lyeth v. Hoey*, 305 U.S. 188, 196; *Freda v. Comm'r*, 656 F.3d 570, 574 (7th Cir. 2011); *Alexander v. IRS*, 72 F.3d 938, 942 (1st Cir. 1995). The government's

position here inters that tenet in the graveyard of forgotten canons.

When an FCA claim is tried rather than settled, there will performe be no characterization agreement available to guide the tax treatment of awarded damages. Nevertheless, some portion of the award beyond single damages may subsequently be found to have a compensatory purpose. See *Chandler*, 538 U.S. at 130–31; *Bornstein*, 423 U.S. at 315. Hence, that portion of the award will be deductible. See 26 C.F.R. §1.162-21(b). The same result logically should obtain in the settlement context. Thus, a rule that requires a tax characterization agreement as a precondition to deductibility would produce an infelicitous asymmetry.

The First Circuit acknowledged that its holding was somewhat at odds with the Ninth Circuit’s decision in *Talley Industries Inc. v. Commissioner*, 116 F.3d 382 (1997), but it described *Talley Industries* as “distinguishable on its facts,” and said “its message is unclear,” concluding that “generally accepted principles of tax law compel us to part company with the Ninth Circuit.”

**4. The Tax Court shows some more love for captive insurance companies.** *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (1/14/14). The parent of an affiliated group of domestic corporations (RAC) conducted its business through stores owned and operated by its subsidiaries. The parent established a Bermudian insurance company (Legacy) and the operating subsidiaries entered into insurance contracts with Legacy pursuant to which each subsidiary paid Legacy an amount, determined by actuarial calculations and an allocation formula, relating to workers’ compensation, automobile, and general liability risks. Legacy, in turn, reimbursed a portion of each subsidiary’s claims relating to these risks. Although the parent corporation was a listed policyholder, no premium was attributable to it because it did not own stores, have employees, or operate vehicles. RAC paid the premiums relating to each policy. The operating subsidiaries deducted, as insurance expenses, the payments to Legacy. In addition, in a complex arrangement, RAC guaranteed up to \$25 million of Legacy’s liabilities, and the guaranty was treated as an asset of Legacy by the Bermudian insurance regulators. The IRS issued a deficiency notice based on the position that the payments by the operating subsidiaries to Legacy were not deductible as insurance premiums. The Tax Court, in a reviewed opinion (7-3-6) by Judge Foley, held that the payments were deductible as insurance premiums. First, in forming Legacy, RAC “made a business decision premised on a myriad of

significant and legitimate nontax considerations.” Second, the flow of funds was not circular. Third, Legacy was not a “sham,” but “was a bona fide insurance company.” Legacy “charged actuarially determined premiums; was subject to the BMA’s regulatory control; met Bermuda’s minimum statutory requirements; paid claims from its separately maintained account; and, as respondent’s expert readily admitted, was adequately capitalized.” Finally, the payments were insurance premiums because the policies shifted risk between RAC’s operating subsidiaries and Legacy. Under the principles of *Humana Inc. & Subs. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), *aff’g in part, rev’g in part and remanding*, 88 T.C. 197 (1987), because the subsidiaries owned no stock in the captive insurance company, risk was shifted and distributed. The court expressly rejected adoption of the IRS’s “economic family theory,” *see* Rev. Rul. 77-316, 1977-2 C.B. 53, as have other courts that have examined the issue.

- Judge Foley found RAC’s guarantee of up to \$25 million of Legacy’s liabilities not to be relevant. Legacy’s guaranty did not affect the balance sheets or net worth of the operating subsidiaries insured by Legacy.

- In a dissenting opinion, Judge Halpern, joined by Judge Lauber, discussed the lack of clarity in Judge Foley’s opinion concerning whether the court has overruled its prior decision in *Humana*, in which the Tax Court concluded that a brother-sister captive insurance arrangement was not insurance for federal tax purposes. He emphasized that, to overrule a prior decision, the Tax Court’s Conference Procedures require an affirmative vote of a majority of judges entitled to vote and that, although the votes of the three judges who concurred in the result count as affirmative votes, “[w]hether the Court has in fact overruled a portion of *Humana* undoubtedly will be unclear to many readers of this report.” Judge Halpern stated that, to the extent the court’s prior decision in *Humana* stands for the proposition that a captive insurance arrangement between brother-sister corporations cannot be insurance a matter of law, it was unnecessary for the court to revisit *Humana* in light of the IRS’s position, expressed in Rev. Rul. 2001-31, 2001 C.B. 1348, that it would no longer invoke the “economic family” theory with respect to captive insurance transactions and instead would assess such transactions based on the facts and circumstances of each case.

- Judge Lauber wrote a dissenting opinion in which five judges joined. Judge Lauber, for the same reasons expressed by Judge Halpern, saw “no need for the Court to reconsider *Humana*, which in a practical sense may be water under the bridge.” He agreed with the majority that the deductibility of the insurance premiums should be assessed taking into account the facts and circumstances of the case, but concluded that “the undisputed facts of the entire record warrant the opposite conclusion from that reached by the majority and justify a ruling that the Rent-A-Center arrangements

do not constitute ‘insurance’ for Federal income tax purposes.” As the basis for his conclusion, Judge Lauber focused on (1) the lack of risk shifting, evidenced by the combination of RAC’s guaranty of Legacy’s liabilities and Legacy’s inadequate capitalization, and (2) several factors demonstrating that RAC, Legacy and the operating subsidiaries had failed to “conduct themselves in a manner consistent with accepted insurance industry norms.

**a. Another big hug from the Tax Court for captive insurance companies.** Securitas Holdings, Inc. v. Commissioner, T.C. Memo. 2014-225 (10/29/14). Securitas AB, a public, Swedish company that provides guarding and security services throughout Europe and other markets, operates in the U.S. through an affiliated group of corporations of which the parent is Securitas Holdings, Inc. (SHI). SHI acquired a U.S. captive insurance company, Protectors Insurance Company of Vermont (Protectors). During 2003 and 2004, the operating subsidiaries of SHI maintained their coverage with third-party insurers for various insurable risks, including workers’ compensation, automobile, employment practices, general, and fidelity liabilities. Protectors insured most of the operating subsidiaries up to the deductible or self-insured retentions of the third-party policies. SHI guaranteed the performance of Protectors with respect to these risks. SHI did so to preserve the tax-exempt status under § 501(c)(15) of another subsidiary and took the position that Protectors did not qualify as an insurance company for federal income tax purposes during the years in issue. SHI never paid any amounts on the guaranty. Protectors requested certain relief from the Vermont insurance regulators, including permission to lend all but \$1 million of its capital to SHI. The risks insured under the policies issued by Protectors were reinsured by a newly-formed captive insurance company formed by Securitas AB in Ireland. The Tax Court (Judge Buch) held that the premiums paid by the operating subsidiaries were deductible under § 162. The court examined four criteria commonly used by courts to determine whether an arrangement constitutes insurance for federal tax purposes and concluded that the captive arrangement was insurance because it: (1) shifted risk from the operating subsidiaries to Protectors and ultimately to the Irish captive reinsurance company; (2) distributed risk by insuring a large pool of differing risks; and (3) constituted insurance in the commonly accepted sense. (The IRS conceded that the arrangement involved insurable risks, which is the fourth criterion.) In reaching these conclusions, the court rejected several arguments made by the government. The court held that SHI’s guaranty did not negate risk shifting based on its prior holding in Rent-A-Center, Inc. v. Commissioner, 142 T.C. No. 1 (1/14/14) and its conclusion that SHI’s captive arrangement was distinguishable from the one in Hospital Corp. of America v. Commissioner, T.C. Memo. 1997-482. The court also rejected the government’s argument that

the group's manner of paying claims and premiums through journal entries that tracked amounts receivable and payable prevented risk from shifting.

**5. “[T]he dissipation, in recent times, of the historical moral opposition to gambling does not undercut the ‘rational basis’ for treating professional gambling losses differently from other business-related losses.”** Lakhani v. Commissioner, 142 T.C. No. 8 (3/11/14). The Tax Court (Judge Halpern) held that a professional gambler could not deduct under §§ 162, 212, or 165 that portion of each bet equal to the takeout percentage that applies to the pari-mutuel pool formed to receive that bet. Section 165(d) disallowed the loss.

**6. A self-employed truck driver lacking receipts for travel expenses gets to sing ♪Yankee Doodle Dandy.♪** Baker v. Commissioner, T.C. Memo. 2014-122 (6/18/14). The taxpayer was a self-employed trucker who used his own truck tractor to haul tank trailers from a pickup site to designated destinations. He failed to file a tax return and the IRS prepared a substitute return, based on third-party payors' information returns, that allowed no deductions. In disputing the deficiency, the taxpayer claimed that various expenses of operating his trucking business should have been allowed notwithstanding that he had no records. Because the truck was used in the business of transporting property, pursuant to § 280F(d)(4)(C) it was not listed property. Accordingly, the taxpayer's claimed expenses for fuel, maintenance, insurance, oil changes, storage fees, license plates, and heavy highway use taxes, incurred with respect to the truck, were not subject to the § 274(d) substantiation requirements and some of the claimed expenses were allowed under *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) because the Tax Court (Judge Ruwe) found that the taxpayer had credibly testified about his business and the expenses. However, only a very small portion of the claimed expenses were allowed.

**7. Intention to operate a rental business doesn't establish its operation.** Hume v. Commissioner, T.C. Memo. 2014-135 (7/7/14). The taxpayers claimed mortgage interest deductions on Schedule C for a residential property they owned and had acquired with an intention eventually to rent out, but in which they resided in the years in question. The Tax Court (Judge Wherry) upheld the IRS's determination that the taxpayers were not entitled to Schedule C deductions because the property was a personal residence. Although nothing in the record contradicted the taxpayer's testimony that he purchased the property with the purpose of renting it out for profit, and the record arguably reflected “that he may have regularly and actively engaged in efforts to further and promote the activity,” his testimony

that he never was able to get the property into a “condition to be able to” rent it, and the fact that he was residing in it, contradicted any argument that the taxpayers were renting out or able to rent out the property for the years in question. The taxpayers were able to deduct the mortgage interest payments only as qualified residence interest on Schedule A, Itemized Deductions, subject to the \$1.1 million § 163(h) limitation. The remaining mortgage interest paid was not deductible.

**8. Price-fixing in the E.U. results in an increased U.S. income tax liability.** Guardian Industries Corp. v. Commissioner, 143 T.C. No. 1 (7/17/14). The Tax Court (Judge Lauber) sustained the IRS’s determination that § 162(f) disallowed a deduction for a €20 million penalty paid to the Commission of the European Community (EC) as a result of the Commission’s determination that the taxpayer participated in prohibited price fixing. The phrase “government of a foreign country,” as used in Reg. § 1.162-21(a), refers both to the government of a single foreign country and to the governments of two or more foreign countries, and the Commission was an entity serving as an instrumentality of the EC member states within the meaning of Reg. § 1.162-21(a). The court rejected the taxpayer’s argument that “an agency or instrumentality must be below a government,” finding that “[t]he fact that the Commission is not subordinate to, or subject to the control of, any individual member state thus has little relevance in deciding whether it is an ‘agency or instrumentality’ of the member states collectively.”

**9. So, maybe not reporting that barter rental income wasn’t such a bright idea after all.** Meinhardt v. Commissioner, 766 F.3d 917 (8th Cir. 9/10/14). The taxpayers owned 140 acres of farmland in rural Minnesota and an eighty-year-old farmhouse in need of substantial repair and renovation. At times they farmed the land themselves, but they regularly rented the farmland to neighboring farmers for cash rent. They never rented out the farmhouse for cash, but “rented” it to people who performed services on the property or allowed relatives who performed services to use it free of cash rent. They never reported any barter income and had no records of the value of the services received. However, they deducted substantial expenses relating to the farmhouse and its outbuildings, which were disallowed by the IRS, because the farmland was the only part of the property that was leased and from which income was derived. The Tax Court upheld the disallowance of the deductions because the farmhouse expenses “were [not] tied to a real estate property rental business” (I.R.C. § 162) or related to “property held for the production of income” (I.R.C. § 212). The Court of Appeals, in a decision by Judge Loken, affirmed.

[E]vidence the Meinhardts made no changes in their efforts to rent the property, despite thirty unsuccessful years, undermined their assertion that they sought to profit by renting the property. The lack of evidence of a rental property business strategy, and evidence they allowed relatives to live in the house rent-free, supported a finding that the Meinhardts held the property as an alternative residence for the personal use of their extended family.

The court also rejected the taxpayer's argument that "the entire farm was 'a single rental business involving multiple related undertakings' and therefore all expenses of that single business, including the farmhouse expenses, were deductible," relying on Reg. § 1.183-1(d)(1), which deals with the scope of an "activity" for purposes of the "hobby loss" rules. The Tax Court's fact finding that the taxpayer "differentiated the farmland from the farmhouse and rented out the farmland separately," and "did not abandon all personal use of the farmhouse," was not clearly erroneous. There was no evidence they ever tried to rent or lease the farmhouse and farmland together. Nor did the taxpayer hold the farmhouse for the production of income under § 212. "[T]hey 'did nothing to generate revenue during the years in issue [and] had no credible plan for operating it profitably in the future.'"

**10. Don Draper likely would have tried to take advantage of this rule had it been around when he was renting hotel rooms in NYC.** T.D. 9696, Local Lodging Expenses, 79 F.R. 59112 (10/1/14). The Treasury Department has promulgated Reg. § 1.162-32 (proposed as Reg. § 1.162-31 in REG-137589-07, Local Lodging Expenses, 77 F.R. 24657 (4/25/12)) with minor clarifications. Reg. § 1.162-32 allows a deduction for local lodging—i.e., lodging while the taxpayer is not away from home—in carrying on a taxpayer's trade or business (whether or not as an employee) under a "facts and circumstances" test. One factor is whether the taxpayer incurs the expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. To the extent an employer reimburses an employee for local lodging expenses, the reimbursement may be excluded from the employee's gross income if the expense allowance arrangement satisfies the requirements of an accountable plan under § 62(c) and the applicable regulations. The regulations provide a safe harbor for local lodging at business meetings and conferences. A taxpayer's local lodging expenses that do not satisfy the safe harbor nevertheless may be deductible depending on the taxpayer's facts and circumstances. The examples indicate that there must be a bona fide business reason for the overnight stay, and, if provided by an employer, there must be a substantial noncompensatory reason. The regulations apply to expenses paid or incurred after 9/30/13, but taxpayers

may apply the regulations to expenses paid or incurred in taxable years ending before 10/1/14, for which the period of limitation on credit or refund under § 6511 has not expired.

- We foresee a deluge of future Tax Court cases involving deductions claimed for nights (or mid-day stays) at a host of no-tell motels.

#### **11. Wouldn't it be better to increase teachers' pay?**

TIPA retroactively extended through 2014 the § 62(a)(2)(D) above-the-line deduction for up to \$250 of teachers' classroom supplies expenses.

### **E. Depreciation & Amortization**

**1. New accounting and disposition rules for MACRS property.** T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The capitalization and repair regulations (discussed above) provide significant new rules for the maintenance of multiple asset accounts and disposition of property from MACRS single and multiple asset accounts.

- *Accounting for MACRS Property.* Consistent with prior rules under Reg. § 1.167-7, Temp. Reg. § 1.168(i)-7T allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in a multiple asset account. Assets in a multiple asset account must have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to additional first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. Assets with the same recovery periods and conventions may be combined in a multiple asset account even if the assets have different uses. In addition, the taxpayer is permitted to use as many single and multiple asset accounts as the taxpayer may choose.

- *Dispositions.* Temp. Reg. § 1.168(i)-8T(d) defines a disposition of MACRS property as occurring when the asset is transferred or permanently withdrawn from use in the taxpayer's trade or business or from the production of income. Thus, a disposition includes the sale, exchange, retirement, abandonment, or destruction of an asset. Significantly, the

definition of disposition is expanded in the temporary regulation to include the retirement of a structural component of a building.

- *Gain or Loss.* Gain or loss on the sale, exchange, or conversion of an asset is determined under applicable tax principles. Loss on abandonment is determined from the “adjusted depreciable basis” of the asset (basis adjusted for depreciation). Temp. Reg. § 1.168(i)-8T(d). Recognized loss on other dispositions is the excess of the adjusted depreciable basis of the asset over fair market value. Identification of the asset disposed of from a multiple asset account, and its basis, is generally determined from the taxpayer’s records. Temp. Reg. § 1.168(i)-8T(e), (f). The temporary regulations provide rules for identifying assets if the taxpayer’s records do not do so; a first-in first-out (FIFO) method, a modified FIFO method, a mortality dispersion table method, or any other method designated by the IRS. The asset cannot be larger than a unit of property. In the case of a disposition of a structural component of a building, the structural component is the asset disposed of. An improvement placed in service after the asset is treated as a separate asset provided that it is not larger than the unit of property. Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E). Disposition of an asset in a single asset account terminates depreciation for the asset as of the time of the disposition. Disposition of an asset in a multiple asset account removes the asset from the account as of the beginning of the year of disposition, requires separate depreciation for the asset in the year of disposition and reduction of the depreciation reserve of the multiple asset account by the unadjusted basis of the disposed asset as of the first day of the taxable year of the disposition. Temp. Reg. § 1.168(i)-8T(g).

- *General Asset Accounts.* Consistent with prior Reg. § 1.168(i)-1, the temporary regulations provide for an election to group assets into one or more general asset accounts. Temp. Reg. § 1.168(i)-1T(c)(2) provides for grouping assets in a general asset account as long as the assets have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. The temporary regulations do not include the requirement of prior regulations that general asset accounts include only assets in the same asset class. Assets eligible for additional first year depreciation deductions must be grouped with assets eligible for the same first year depreciation deductions and may not be grouped with assets not eligible for additional first year depreciation. Temp. Reg. § 1.168(i)-1T(c)(2)(ii)(D), (E). The temporary regulations expand existing rules for dispositions of assets from a general asset account to encompass as a disposition the retirement of a structural component of a building. As under existing rules, the temporary regulations treat the basis of any asset disposed of from a general asset account as zero, and any amount realized results in ordinary gain. The taxpayer continues to depreciate

assets in the general asset account as if no disposition occurred. Temp. Reg. § 1.168(i)-1T(e)(2). However, consistent with existing regulations, the temporary regulations allow a taxpayer to elect to terminate general asset account treatment on disposition of an asset in a qualifying disposition, in which case gain or loss is recognized under the rules of Temp. Reg. § 1.168(i)-8T. The list of qualifying dispositions is expanded generally to include any disposition. Temp. Reg. § 1.168(i)-1T(e)(3). In addition, general asset accounts are terminated in certain nonrecognition dispositions and on termination of a partnership under § 708(b)(1)(B). Gain or loss may also be recognized on disposition of all of the assets, or the last asset, in a general asset account. Temp. Reg. § 1.168(i)-1T(e)(3)(ii).

**a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations relating to depreciation of tangible property.** Rev. Proc. 2012-20, 2012-14 I.R.B. 700 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp. Reg. §§ 1.167(a)-4T (amortizing or depreciating leasehold improvements), 1.168(i)-1T (rules for general asset accounts), 1.168(i)-7T (accounting for MACRS property), and 1.168(i)-8T (dispositions of MACRS property), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). The automatic change of accounting method of Rev. Proc. 2011-14, 2011-1 C.B. 330, is applicable to property placed in service in a taxable year ending after 12/29/03. With respect to assets placed in service in a taxable year ending before 12/30/03, adopting the methods of the temporary regulations requires an amended return for open years, including the placed in service years and all subsequent years. No § 481 adjustment is required or permitted with respect to the amended returns.

**b. LB&I provides guidance under Rev. Proc. 2012-20.** LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

**c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance announced that pending final regulations will apply only in years beginning in 2014 and thereafter.** Notice 2012-73, 2012-51 I.R.B. 713 (11/20/12). The IRS announced that pending final regulations will apply to taxable years beginning on or after 1/1/14, but that taxpayers will be permitted to apply the final regulations to taxable years beginning on or after

1/1/12. The notice also indicates that the temporary regulations may be revised with respect to the de minimis rule of § 1.263(a)-2T(g), dispositions under §§ 1.168(i)-1T and 1.168(i)-8T, and the Safe Harbor for Routine Maintenance under § 1.263(a)-3T(g).

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

**e. New, new rules relating to accounting for MACRS property.** T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 F.R. 57686 (9/19/13). The Treasury Department and IRS have promulgated final regulations under § 168 for the maintenance of multiple asset accounts that were proposed in REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11), and replaced the temporary regulations promulgated in T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). Consistent with prior rules under Reg. § 1.167-7 and Temp. Reg. § 1.168(i)-7T, final Reg. § 1.168(i)-7 allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in a multiple asset account. Assets in a multiple asset account must have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to additional first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. Assets with the same recovery periods and conventions may be combined in a multiple asset account even if the assets have different uses. In addition, the taxpayer is permitted to use as many single and multiple asset accounts as the taxpayer may choose. The new provisions are effective for years beginning after 1/1/14, with an election to apply them retroactively to years beginning on or after 1/1/12. A taxpayer may choose to apply Temp. Reg. § 1.168(i)-7T to taxable years beginning on or after 1/1/12, and before 1/1/14.

- Temp. Reg. § 1.168(i)-1T(c), dealing with general asset accounts, and Temp. Reg. § 1.168(i)-8T(d), dealing with dispositions, both of which were promulgated in T.D. 9564 (12/27/11) and

proposed in REG-168745-03 (12/27/11), have not been replaced by final regulations.

**f. IRS specifies the procedures for changes in methods of accounting for dispositions of tangible depreciable property.** Rev. Proc. 2014-17, 2014-12 I.R.B. 661 (3/17/14). In a revenue procedure that supersedes Rev. Proc. 2012-20, the IRS has provided lengthy and detailed rules regarding certain changes in methods of accounting for dispositions of tangible depreciable property. The revenue procedure provides the procedures by which a taxpayer can obtain automatic consent to change to the methods of accounting provided in the regulations related to amortizing or depreciating leasehold improvements (Reg. § 1.167(a)-4 and Temp. Reg. § 1.167(a)-4T), accounting for MACRS property (Reg. § 1.168(i)-7, Temp. Reg. § 1.168(i)-7T, and Prop. Reg. 1.168(i)-7), dispositions of MACRS property (Temp. Reg. § 1.168(i)-8T and Prop. Reg. 1.168(i)-8), and general asset accounts (Temp. Reg. § 1.168(i)-1T and Prop. Reg. § 1.168(i)-1). The revenue procedure also modifies Rev. Proc. 2011-14 by adding new accounting method changes to the Appendix of Rev. Proc. 2011-14, which provides the procedures by which a taxpayer can obtain automatic consent to a change in method of accounting.

**g. Final accounting and disposition rules for MACRS property.** T.D. 9689, Guidance Regarding Dispositions of Tangible Depreciable Property, 79 F.R. 48661 (8/18/14). The Treasury Department has finalized regulations proposed in REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11), and removed corresponding temporary regulations (T.D. 9564, Guidance Regarding Dispositions of Tangible Depreciable Property, 76 F.R. 81060 (12/27/11)).

- *Multiple asset accounts for MACRS property.* Consistent with prior rules under Reg. § 1.167-7, Reg. § 1.168(i)-7, as finalized in 2013, allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in a multiple asset account. Assets in a multiple asset account must have been placed in service in the same taxable year, have the same recovery period, and have the same convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to additional first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. Assets with the same recovery periods and conventions may be combined in a multiple asset account even if the assets have different uses. In

addition, the taxpayer is permitted to use as many single and multiple asset accounts as the taxpayer may choose.

- *General asset accounts.* Consistent with prior Reg. § 1.168(i)-1, as amended by this T.D., Reg. § 1.168(i)-1 allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in general asset accounts as long as the assets have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. The regulations, like the temporary regulations, do not include the requirement of prior regulations that general asset accounts include only assets in the same asset class. Assets with the same recovery periods and conventions may be combined in a general asset account even if the assets have different uses. Assets eligible for additional first year depreciation deductions must be grouped with assets eligible for the same first year depreciation deductions and may not be grouped with assets not eligible for additional first year depreciation. Reg. § 1.168(i)-1(c)(2)(ii)(D), (E). A taxpayer is permitted to use as many single and general asset accounts as the taxpayer may choose. A taxpayer must account for an asset in a single asset account if the taxpayer uses the asset both in a trade or business, for the production of income and in a personal activity, or if the taxpayer places in service and disposes of the asset during the same taxable year. Reg. § 1.168-7(b).

- *Dispositions.* Reg. § 1.168(i)-8(b)(2) defines a disposition of MACRS property as occurring when the asset is transferred or permanently withdrawn from use in the taxpayer's trade or business or from the production of income. Thus, a disposition includes the sale, exchange, retirement, abandonment, or destruction of an asset. Significantly, the definition of disposition includes the retirement of a structural component of a building. A disposition includes a disposition of a portion of an asset as a result of a casualty event (§ 165), a disposition of a portion of an asset for which gain is not recognized in whole or in part under § 1031 or § 1033, a transfer of a portion of an asset in a §§ 332, 351, 361, 721, or 731 transaction, or a sale of a portion of an asset. Reg. § 1.168-8(d).

- *Gain or loss.* Gain or loss on the sale, exchange, or conversion of an asset is determined under applicable tax principles. Loss on abandonment is determined from the "adjusted depreciable basis" of the asset (basis adjusted for depreciation). Reg. § 1.168(i)-8(e). Recognized loss on other dispositions is the excess of the adjusted depreciable basis of the asset over fair market value. Disposition of an asset in a single asset account terminates depreciation for the asset as of the time of the disposition. If the taxpayer accounts for the asset disposed of in a multiple asset account or pool and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the

asset disposed of, the taxpayer may use any reasonable method that is consistently applied to all assets in the same multiple asset account. Reg. § 1.168-8(e). Identification of the asset disposed of from a multiple asset account, and its basis, is generally determined from the taxpayer's records. Reg. § 1.168(i)-8(f), (g). If the taxpayer's records do not identify assets, a first-in first-out method, a modified FIFO method, a mortality dispersion table method, or any other method designated by the IRS may be used. The asset cannot be larger than a unit of property. In the case of a disposition of a structural component of a building, the structural component is the asset disposed of. An improvement placed in service after the asset is treated as a separate asset. Reg. § 1.168(i)-8(e)(4).

- *Disposition of an asset in a general asset account.* Upon disposition of an asset in a general asset account, the asset's basis is deemed to be zero, no loss is allowed, and the amount realized is treated as ordinary income. The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected as a result of a disposition of an asset (or a portion of an asset) from the general asset account. Reg. § 1.168(i)-8(e)(2). Consistent with prior regulations, the regulations allow an election to terminate general asset account treatment of an asset disposed of in certain qualifying dispositions, in which case a loss may be realized upon disposition of an asset (or a portion of an asset) previously included in the general asset account. Reg. § 1.168-1(e)(3)(iii). A qualifying disposition is a disposition that does not involve all the assets, the last asset, or the remaining portion of the last asset, remaining in a general asset account and that is: (1) a direct result of a fire, storm, shipwreck, or other casualty, or from theft; (2) a charitable contribution for which a deduction is allowable under § 170; (3) a direct result of a cessation, termination, or disposition of a business, manufacturing, or other income producing process, operation, facility, plant, or other unit (other than by transfer to a supplies, scrap, or similar account); or (4) generally a transaction to which a nonrecognition section applies. In addition, general asset accounts are terminated on termination of a partnership under § 708(b)(1)(B). Gain or loss may also be recognized on disposition of all of the assets, or the last asset, in a general asset account. Reg. § 1.168(i)-1(e)(3)(ii).

- *Effective date.* The final regulations generally apply to tax years beginning after 12/31/14. A taxpayer may apply them to tax years beginning after 12/31/11, or may apply the temporary regulations to tax years beginning after 12/31/12 and before 1/1/14.

**2. “[F. Scott] Fitzgerald asserted that ‘the very rich \* \* \* are different from you and me.’”** *Brown v. Commissioner*, T.C. Memo. 2013-275 (12/3/13). On December 30, 2003, the taxpayer, an extraordinarily successful insurance salesman, took ownership of a \$22 million airplane in Portland, Oregon. He flew from there to Seattle to Chicago for what he claimed were business meetings, and then back to Portland. The taxpayer

argued that these flights put the plane in service in 2003, thereby entitling him to 50 percent bonus-depreciation under § 168(k)(4), as enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 201, 117 Stat. at 756, which was available for certain qualified property placed in service before January 1, 2004. However, a few days later he had the airplane flown to a plant in Illinois where it underwent modifications costing more than \$500,000—including the installation of a conference table and equipment for PowerPoint presentations—that were completed about a month later. The IRS disallowed the claimed depreciation deductions on the ground that as a result of the additional modifications, the airplane had not been put into service until 2004. The Tax Court (Judge Holmes) evaluated the evidence introduced to support the taxpayer's claim that the Seattle trip resulted in the airplane being placed in service in 2003, and the evaluation is best summarized by the statement that "we sense something doesn't smell quite right with the whole Seattle visit." Among other things, the flight logs indicated a trip of much shorter duration than claimed in the taxpayer's testimony, and a letter from the client with whom the taxpayer claimed to have met thanking him for the visit appeared to have been prepared by one of the taxpayer's employees and presented to the client for his signature after the audit had commenced. More importantly, turning to the question of what "placed in service" means, Judge Holmes concluded that because the taxpayer wanted an airplane on which business meetings could be held, and not merely for transportation, the modifications made in 2004 were necessary for full operation of the airplane in the taxpayer's insurance business on a regular basis—the taxpayer testified that the "modifications were 'necessary' and 'required'"—the airplane had not been placed in service until 2004. Thus, it did not qualify for bonus depreciation. Although Judge Holmes declined to uphold the IRS's assessment of a civil fraud penalty, he did uphold a § 6662 substantial understatement penalty.

**3. 2014 depreciation tables for business autos, light trucks.** Rev. Proc. 2014-21, 2014-11 I.R.B. 641 (3/10/14). The IRS published depreciation tables with the depreciation limits for business use of small vehicles. (There no longer is any § 168(k) first year recovery; it expired.):

*Passenger Automobiles:*

<i>1st Tax Year</i>	<i>\$3,160</i>
<i>2nd Tax Year</i>	<i>\$5,100</i>
<i>3rd Tax Year</i>	<i>\$3,050</i>
<i>Each Succeeding Year</i>	<i>\$1,875</i>

*Trucks and Vans:*

<i>1st Tax Year</i>	\$3,460
<i>2nd Tax Year</i>	\$5,400
<i>3rd Tax Year</i>	\$3,350
<i>Each Succeeding Year</i>	\$1,975

**a. And the IRS claims a mulligan when bonus depreciation is retroactively extended to 2014 by TIPA Rev. Proc. 2015-19, 2015-8 I.R.B. 656 (2/6/15).** The IRS has published depreciation tables with the depreciation limits for business use of small vehicles:

*2014 Passenger Automobiles with § 168(k) first year recovery,*

<i>1st Tax Year</i>	\$11,160
<i>2nd Tax Year</i>	\$ 5,100
<i>3rd Tax Year</i>	\$ 3,050
<i>Each Succeeding Year</i>	\$ 1,875

*2014 Trucks and Vans with § 168(k) first year recovery,*

<i>1st Tax Year</i>	\$11,460
<i>2nd Tax Year</i>	\$ 5,500
<i>3rd Tax Year</i>	\$ 3,550
<i>Each Succeeding Year</i>	\$ 1,975

*2015 Passenger Automobiles (no § 168(k) first year recovery),*

<i>1st Tax Year</i>	\$ 3,160
<i>2nd Tax Year</i>	\$ 5,100
<i>3rd Tax Year</i>	\$ 3,050
<i>Each Succeeding Year</i>	\$ 1,875

*2015 Trucks and Vans (no § 168(k) first year recovery),*

<i>1st Tax Year</i>	\$ 3,460
<i>2nd Tax Year</i>	\$ 5,400
<i>3rd Tax Year</i>	\$ 3,350
<i>Each Succeeding Year</i>	\$ 1,975

- The revenue procedure also has tables for leased vehicles.

**4. Tangible assets used in converting corn to fuel grade ethanol are in asset class 49.5 and therefore have a recovery period of seven years under the general depreciation system.** Rev. Rul. 2014-17, 2014-24 I.R.B. 1093 (5/20/14). This ruling addresses the proper asset class

under Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, for the depreciation of tangible assets that are used in converting corn to fuel grade ethanol. The ruling concludes that, subject to certain exceptions, such assets are in asset class 49.5, Waste Reduction and Resource Recovery Plants. These assets have a class life of ten years under Rev. Proc. 87-56 and, therefore, under § 168(c) and (e), have a recovery period of seven years under the general depreciation system. (The ruling rejects placing such assets in asset class 28.0, Manufacture of Chemicals and Allied Products, which would have provided a recovery period of five years under the general depreciation system.) The IRS states in the ruling that it “will not apply the holding in this revenue ruling to tangible assets that are used in converting biomass to a liquid fuel such as fuel grade ethanol that a taxpayer places in service before June 9, 2014.”

**5. Certain depreciation and amortization provisions of TIPA:**

**a. Enacting an incentive after the expenditure was either made or not made. Only our Congress could find this logical.** TIPA retroactively extended through 12/31/14 § 168(k)(2) bonus depreciation for MACRS property with a recovery period of 20 years or less, computer software (other than computer software subject to § 197), qualified leasehold improvement property, and certain water utility property the original use of which commenced with the taxpayer. It also extended through 12/31/14 the § 168(k)(4) election to increase the AMT limitation in lieu of claiming bonus depreciation.

**b. Special interests rule!** TIPA retroactively extended through 12/31/14 §§ 168(e)(3)(E)(iv), 168(e)(3)(E)(v), and 168(e)(3)(E)(ix), which treat as 15-year property qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, respectively. Qualified retail improvement property and qualified restaurant property also are eligible for § 168(k) 50-percent bonus first-year depreciation if they also meet the definition of qualified leasehold improvement property.

**c. Really narrow special interests rule.** TIPA retroactively extended through 12/31/14 the § 168(i) 7-year straight line cost recovery period for motorsports entertainment complexes.

**d. Do we see Mitch McConnell’s fingerprints here?** TIPA retroactively extended through 12/31/14 the classification of

certain race horses as 3-year MACRS property. It also extended the election under § 179E to treat 50 percent of the cost of any qualified mine safety equipment as an expense in the tax year in which the equipment is placed in service.

**e. Why not just permanently repeal capitalization of machinery and equipment for small businesses?** TIPA retroactively extended through 12/31/14 the increased \$500,000 maximum amount that can be expensed under § 179 and the increased \$2 million expenditure ceiling phase-out amount. For years beginning after 2014, the maximum amount is again scheduled to drop to \$25,000 and the phase-out ceiling is scheduled to drop to \$200,000. It also extended through 2014 the eligibility for § 179 expensing of off-the-shelf computer software, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The latter three categories are subject to a \$250,000 limit on the amount that can be expensed.

**f. Of course we need better tax treatment of luxury cars—Let’s incentivize purchases of Mercedes, BMWs, and Lexuses to boost the American auto industry. What, they’re not American? Surely you jest!** TIPA retroactively extended through 12/31/14 the \$8,000 increase in the first-year § 280F ceiling on depreciation deductions with respect to automobiles, light trucks, vans, and SUVs that are rated at not more than 6,000 pounds gross vehicle weight.

## F. Credits

**1. With “a little song, a little dance,” the Fifth Circuit holds that the *Cohan* rule permits courts to estimate qualified research expenditures.** United States v. McFerrin, 570 F.3d 672 (5th Cir. 6/9/09). Through a clerical error, the IRS granted the taxpayer’s claim for a refund that was based on § 41 research credits previously unclaimed on taxpayer’s return, but claimed on an amended return prepared by alliantgroup. In the IRS suit to recover the refund, the burden of proof fell on the IRS. Reversing the District Court, the Fifth Circuit held that under the rule of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), if the taxpayer can demonstrate that his activities were qualified research, then the trial court can estimate the expenses associated with those activities. In addition, the court held that the District Court erred in not reviewing the claimed research activities under the 2003 final regulations defining “discovery.” The taxpayer’s claim for refund was based on language of regulations proposed in 2001, the preamble to which indicated that

taxpayers could rely on the test of the proposed regulations. The case was remanded to the District Court for reconsideration under the 2003 regulations.

- Former IRS Commissioner Mark Everson has joined alliantgroup as vice chair.

**a. The Fifth Circuit again sided with a taxpayer, this time on the application of the Reg. § 1.41-3(d)(1) consistency rule.** *Trinity Industries, Inc. v. United States*, 757 F.3d 400 (5th Cir. 7/2/14), *aff'g in part, vacating, and remanding in part* 691 F. Supp. 2d 688 (N.D. Tex. 1/29/10). The Fifth Circuit (Judge Owen) remanded this research credit case to the District Court for a determination of whether it violated the Reg. § 1.41-3(d)(1) consistency rule by including in base period “qualified research expenses” (QREs) amounts that were attributable to four vessels whose construction expenses would not have constituted QREs under the standard articulated in this case by the District Court for the claim years.

**2. The Tax Court just says “no” to R&D credits claimed with 20/20 hindsight provided by alliantgroup.** *Shami v. Commissioner*, T.C. Memo. 2012-78 (3/21/12). The taxpayer’s S corporation hired alliantgroup to conduct § 41 research tax credit studies covering the years in question. The research and development department staff ranged in number from 18 to 27, and included chemists, technicians, and a vice president of research and development who supervised the department. The alliantgroup concluded that the corporation was entitled to claim the § 41 research credit based in part on wages paid to two individuals who were, respectively, its chairman of the board, chief executive officer, president, and secretary (Shami), and its executive vice president and the sole member of its sales and marketing committee (McCall), neither of whom had formal education or training in any physical or biological science or in engineering. The only issue in the case involved credits based on wages paid to the two executives. The taxpayers “failed to provide any documentation that establishe[d] how much time, if any, Mr. Shami or Mr. McCall spent performing research and development services during the relevant years,” but argued that the court “must estimate the amount of wages allocable to qualified services if [it found] either Mr. Shami or Mr. McCall performed qualified services.” The Tax Court (Judge Kroupa) rejected the taxpayer’s argument, on the basis that the *Cohan* rule (*Cohan v. Commissioner*, 39 F.2d 540, 543–44 (2d Cir. 1930)) applies only if there is a reasonable basis on which the court can make an estimate, and that in this case, the taxpayer failed to satisfy the court that there was sufficient evidence to estimate the appropriate allocation of wages between qualified services and nonqualified services. Judge Kroupa found *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009), which did apply the *Cohan* rule in determining the § 41 research credit, to be inapposite, stating that in

*McFerrin* “the Court of Appeals for the Fifth Circuit did not overrule, or even address, the basic requirement under *Cohan* that a court must have a reasonable basis upon which to make an estimate.”

**a. And the Fifth Circuit says that the Tax Court got it mostly correct.** *Shami v. Commissioner*, 741 F.3d 560 (5th Cir. 1/23/14). In an opinion by Judge Owen, the Fifth Circuit affirmed the disallowance of credits with respect to the wages paid to Shami and McCall. The court reasoned that

*Cohan* did not compel the Tax Court to make an estimate in this case. . . . [T]he *Cohan* rule is not implicated unless the taxpayer proves that he is entitled to some amount of tax benefit. In the context of the § 41 credit, a taxpayer would do so by proving that its employee performed some qualified services. In this case, a careful reading of the Tax Court’s opinion reveals that the Tax Court made no such finding.

• However, the Court of Appeals vacated the Tax Court decision to the extent that it disallowed the credit with respect to certain supplies, reasoning that the IRS had conceded this issue in a series of statements at trial and in post-trial briefs, and that the Tax Court improperly failed to take the concession into account in determining the deficiency.

**3. Taxpayers now can make the alternative simplified research credit election on an amended return.** T.D. 9666, Alternative Simplified Credit Election, 79 F.R. 31863 (6/3/14). Section 41(c)(5) provides a “simplified” research credit of 14 percent of so much of the qualified research expenses as exceeds 50 percent of the average qualified research expenses for the three preceding taxable years, or, if the taxpayer has no qualified research expenses in any of the three prior years, the simplified credit is 6 percent of qualified research expenses for the year. (The regular credit under § 41(a)(1) generally is 20 percent of qualified research expenses over a base.) Final regulations as amended in 2011 require that an election for the alternative simplified credit (ASC) be made with the return filed for the year to which the election applies, provide that the election may not be made on an amended return, and state that the IRS will not grant an extension of time to file the election under Reg. § 301.9100-3. T.D. 9528, Alternative Simplified Credit Election, 76 F.R. 33994 (6/10/11). In response to taxpayer requests, Treasury and the IRS have removed from the final regulations the rule in Reg. § 1.41-9(b)(2) that prohibits a taxpayer from making an ASC election for a tax year on an amended return. In place of this rule, temporary

regulations provide that taxpayers can make an ASC election for a tax year on an amended return. However, because of concerns that permitting changes from the regular credit to the ASC on amended returns could result in more than one audit of a taxpayer's research credit for a tax year, the temporary regulations provide that a taxpayer that previously claimed, on an original or amended return, a § 41 credit for a tax year may not make an ASC election for that tax year on an amended return. A taxpayer that is a member of a controlled group in a tax year may not make an ASC election for that tax year on an amended return if any member of the controlled group for that year previously claimed the research credit using a method other than the ASC on an original or amended return for that tax year. The regulations generally apply to elections with respect to tax years ending on or after 6/3/14, but taxpayers can rely on the temporary regulations to make elections for prior tax years if the election is made before the period of limitations for assessment of tax has expired for that year.

**4. More work for tax professionals provided by Obamacare.** T.D. 9672, Tax Credit for Employee Health Insurance Expenses of Small Employers, 79 F.R. 36640 (6/30/14). The Treasury Department has promulgated final regulations (Regs. §§ 1.45R-0 through 1.45R-5) providing guidance under § 45R, added by the Patient Protection and Affordable Care Act, which provides a tax credit to certain small employers that offer health insurance coverage to their employees. The final regulations are effective on 6/30/14 for taxable years beginning after 2013. Alternatively, employers may rely on the proposed regulations (REG-113792-13, Tax Credit for Employee Health Insurance Expenses of Small Employers, 78 F.R. 52719 (8/26/13)) for taxable years beginning after 2013 and before 2015.

**5. Certain credit provisions of TIPA:**

**a. If the research credit first enacted in ERTA 1981 is such a great idea, why not make it permanent?** TIPA retroactively extended through 12/31/14 the § 41 research credit.

**b. We need to promote energy efficiency in the USA because all the Keystone Pipeline oil from Canada is destined for export.** TIPA retroactively extended through 12/31/14 the § 45L credit of \$2,000 or \$1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year.

**c. Extenders, extenders, can't get enough of those extenders.** Other business credits TIPA retroactively extended through 12/31/14 include: (1) the § 51 Work Opportunity Credit; (2) the § 45 credit for electricity produced from certain renewable resources; (3) the § 45G railroad track maintenance credit; (4) the § 45P differential wage credit; (5) the § 45A Indian Employment Credit and the § 45(e)(10) Indian Coal Production Credit; (6) the § 45D New Markets Credit; (7) the § 45N mine rescue team training credit; and (8) a number of others that we have missed or did not care enough about to include.

### **G. Natural Resources Deductions & Credits**

There were no significant developments regarding this topic during 2014.

### **H. Loss Transactions, Bad Debts, and NOLs**

**1. Another case of a doc not understanding tax law.** Dargie v. United States, 742 F.3d 243 (6th Cir. 2/5/14). The Sixth Circuit, in an opinion by Judge Siler, held that repayment of a conditional grant to fund medical degree education was not deductible. The medical education enabled him to meet the prerequisites for working as a physician. Therefore, a deduction was disallowed by Reg. § 1.162-5(b)(2), which categorizes as nondeductible “expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business.”

**2. Seventy months in the slammer, a \$19 million fine, and a \$44 million forfeiture for insider trading was penalty enough.** Nacchio v. United States, 115 Fed. Cl. 195 (3/12/14). The taxpayer was the CEO of Qwest Communications International when he realized profits of approximately \$44 million trading Qwest stock. He was convicted of insider trading, paid a fine of \$19 million, and forfeited \$44 million that was paid over to victims of his securities fraud scheme. (He also was sentenced to 70 months in prison.) On a motion for summary judgment, the Court of Claims (Judge Williams) held that the \$44 million forfeiture was deductible under § 165. Because the forfeiture served to compensate victims of the taxpayer's securities fraud, the payment was not a “fine or similar penalty” that is not deductible pursuant to § 162(f). The court rejected the government's argument that allowing a deduction under § 165 would frustrate public policy, reasoning that “[a]llowing the deduction would not increase the odds in favor of insider trading or destroy the effectiveness of the securities laws.” Furthermore,

“[d]isallowing the deduction would result in a ‘double sting’ by requiring the taxpayers to both make restitution and pay taxes on income they did not retain.” However, whether § 1341 applied required further proceedings because there was a material question of fact whether Nacchio, who did not plead guilty, believed that he had an unrestricted right to the profits in the year he realized them.

## I. At-Risk and Passive Activity Losses

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

**2. A credible taxpayer establishes material participation in an activity conducted in another state, with a little bit of help from IRS stipulations.** Tolin v. Commissioner, T.C. Memo. 2014-65 (4/9/14). The taxpayer, who lived in Minnesota, established that he had devoted sufficient hours to a thoroughbred breeding and racing activity based in Louisiana, through a combination of: (1) credible testimony of his employees and agents regarding the time they spent annually in telephone calls with the taxpayer, coupled with the taxpayer’s telephone records establishing that the calls had been made (300 hours); (2) the amount of time that the IRS stipulated that the taxpayer had spent in Louisiana, coupled with the taxpayer’s testimony and the testimony of third-party witnesses regarding the taxpayer’s workday activities, even though credit card records showed that he engaged in some nonbusiness activity while in Louisiana (150-180 hours); and (3) his preparation and mailing of the promotional breeding packages (the voluminous contents of which were stipulated by the parties) and the miscellaneous administrative tasks he completed (enough hours to reach 500). Thus, the Tax Court (Judge Gale) held that the breeding and racing activity was not a passive activity, and the taxpayer’s deductions for losses related to the activity were not limited by § 469.

**3. Who needs a log book? Material participation established under the “facts and circumstances” test without counting hours—quality is more important than quantity.** Wade v. Commissioner, T.C. Memo. 2014-169 (8/20/14). The husband and wife taxpayers owned

stock in two S corporations that passed through to them losses. The IRS disallowed the losses as passive activity losses subject to § 469. The record established that Mr. Wade spent “over 100 hours participating in TSI and Paragon during 2008, and his participation consisted primarily of nonmanagement and noninvestment activities,” while his son managed the day-to-day operations of the companies. Mr. Wade focused on product development and customer retention. The Tax Court (Judge Goeke) found that Mr. Wade’s “efforts were continuous, regular, and substantial . . . Mr. Wade brought something to [the companies] that no one else could have, and they could not have continued to operate without his contacts and expertise.” Accordingly, pursuant to the “facts and circumstances” test in Reg. § 1.469-5T(a)(7), which requires participation on a “regular, continuous, and substantial basis” during the year, Mr. Wade materially participated in the companies’ activities. That the record did not establish that Mrs. Wade actively participated in the companies was irrelevant because Reg. § 1.469-5T(f)(3) provides that participation by a married taxpayer is treated as participation by his or her spouse. Thus, Mr. Wade’s material participation in the companies was sufficient to establish material participation for Mrs. Wade.

**4. Some questions about whether a trust can be a real estate professional have been answered; others have not.** Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (3/27/14). The taxpayer trust owned a single-member LLC that was a disregarded entity conducting an extensive rental real estate business. Three of the six trustees were full time employees of the LLC; three of the trustees had little or no involvement in the real estate business. The rental real estate business incurred substantial losses, which the trust deducted against income and gains from non-passive activities. The IRS disallowed the losses as passive activity losses, but the trust argued that it qualified as a real estate professional under § 469(c)(7). The Tax Court (Judge Morrison) rejected the IRS’s argument that, except as expressly provided for closely held C corporations in § 469(c)(7)(D)(i), § 469(c)(7) applies only to individual taxpayers. He reasoned that notwithstanding language in Reg. § 1.469-9(b)(4), which deals with § 469(c)(7), that defines “[p]ersonal services” as “work performed by an individual in connection with a trade or business,” the definition of “material participation” in § 469(h) is not so limited. Even though the statute does not provide any rule for how material participation by a trust is determined, and no regulations doing so have been promulgated, nothing in the statute or legislative history limited the application of § 469(c)(7) to individuals and closely held corporations. The IRS further argued that even if § 469(c)(7) could apply to trusts, (1) in determining whether a trust is materially participating in an activity, only the activities of the trustees can be considered and the activities of that trust’s employees must be disregarded, and (2) neither the participation by the

trustees in their capacity as employees of the LLC nor the work of 20 or so non-trustee employees counted toward material participation. Judge Morrison also rejected these arguments. Even if the activities of the trust's non-trustee employees were disregarded, the activities of the trustees were properly considered in determining whether the trust materially participated in the real-estate operations, including their activities as employees of the LLC. On all of the facts, including that two of the trustees "were involved in managing the day-to-day operations of the trust's various real-estate businesses," the trust materially participated in its real-estate operations. Finally, because the IRS limited its arguments to (1) trusts are categorically barred from qualifying under the § 469(c)(7) exception, and (2) the trust did not materially participate in real-property trades or businesses, the court expressly did not address whether (1) more than one-half of the personal services performed in trades or businesses by the trust were performed in real-property trades or businesses, and (2) the trustees performed more than 750 hours of services during the year in the real-property trades or businesses. Accordingly, the trust's rental activities were not passive activities.

**5. An LLC member guarantees debt of the LLC incurred in connection with an aircraft leasing activity and successfully flies around the at risk and passive activity loss rules.** Moreno v. United States, 113 A.F.T.R.2d 2014-2149 (W.D. La. 5/19/14). The taxpayer claimed a \$4.7 million loss arising from the acquisition and leasing of a Learjet aircraft by a disregarded LLC of which he was the sole member. The LLC acquired the aircraft with a loan secured by the aircraft. The loan was guaranteed by both the taxpayer and Dynamic Industries, Inc. (Dynamic), a wholly owned subsidiary of a corporation of which the taxpayer held 98 percent of the stock. The LLC leased the aircraft to six lessees during the tax year in question. The government argued that the taxpayer was not at risk with respect to the aircraft leasing activity. The government conceded that the taxpayer's personal guaranty satisfied § 465(b)(2)(A), which states that a taxpayer is at risk for amounts borrowed for use in an activity to the extent the taxpayer "is personally liable for the repayment of such amounts." Instead, the government argued that the taxpayer was not at risk by virtue of § 465(b)(4), which provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." The court (Judge Doherty) observed that the Fifth Circuit, to which this case is appealable, has not addressed the applicable standard for determining whether a taxpayer is protected against loss within the meaning of § 465(b)(4) and that the majority of Circuits (the Second, Eighth, Ninth, and Eleventh) have adopted an "economic realities" test, while the Sixth Circuit has adopted a "payor of last resort" test. The court concluded that, under either test, the taxpayer was not

protected against loss within the meaning of § 465(b)(4) and was at risk. “Simply put,” the court reasoned, “the failure of [the LLC] to meet the terms of its loan agreement would trigger a demand for payment by [the lender] against Dynamic and/or Moreno.” In reaching this conclusion, the court rejected the government’s arguments that: (1) the taxpayer did not have sufficient liquidity to pay the loan in the event of the LLC’s default (“the government has cited no legal authority ‘that a guarantor must have unencumbered cash or marketable resources to satisfy a claim under a guaranty to be at risk’”); (2) the lender’s internal documents showed that it relied on Dynamic, rather than the taxpayer, to pay the loan upon the LLC’s default (“the government has cited no legal authority in support of its position that where a lender’s internal loan documents purportedly show the lender is relying upon the financial strength of one surety over another surety, the latter surety is no longer to be given ‘at risk’ treatment under section 465, because the foregoing scenario constitutes protection from loss under either the payor of last resort test or the economic reality test”); (3) the taxpayer, as the ultimate controlling shareholder of Dynamic, would ensure that Dynamic paid the loan (“the government’s speculative assertion . . . is insufficient to show Moreno engaged in a prohibited loss-limiting arrangement”); (4) the taxpayer was protected by an indemnity provision in his employment agreement with the parent corporation of Dynamic (“the indemnity provision . . . is [not] sufficiently broad in scope, such that it applies to Moreno’s *personal* guaranty of the [LLC’s] loan”); and (5) if Dynamic were to pay the loan, it would have no right to recover any of its payment from the taxpayer. However, in addressing the government’s fifth argument, the court concluded that the taxpayer and Dynamic each would have a right of contribution against the other if they paid the loan, and therefore the taxpayer was at risk for only 50 percent of the amount guaranteed.

- The government also asserted that the aircraft leasing activity was a passive activity for the taxpayer pursuant to § 469(c)(2), which provides as a general rule that any rental activity is a passive activity. An exception in Reg. § 1.469-1T(e)(3)(ii)(A) provides that “an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year—(A) The average period of customer use for such property is seven days or less[.]” For this purpose, the average period of customer use for a year is calculated by dividing the aggregate number of days in all periods of customer use by the number of periods of customer use. Reg. § 1.469-1(e)(3)(iii)(C). In Reg. § 1.469-1(e)(3)(iii)(D), a period of customer use is defined as follows:

Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses

the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals thereof) is treated for purposes of this paragraph (e)(3)(iii) as a separate period of customer use.

The LLC leased the aircraft to six different lessees during the year under a Non-Exclusive Aircraft Leasing Agreement. The government argued that “each lessee had a continuous and recurring right to use the aircraft from the time each agreement was entered into, through the end of taxable year 2005,” and therefore there were six periods of customer use during the year. After closely analyzing the terms of the lease, however, the court concluded that “[b]ecause the agreement clearly stated a potential lessee’s request [to use the aircraft] could be granted or denied in the owner’s sole discretion, there was no ‘continuous or recurring right’ to use the aircraft, except when the aircraft was in the actual possession of a lessee.” Thus, each period when a lessee was in actual possession of the aircraft was a separate period of customer use. Using this approach, the average period of customer use for the aircraft during the year was “seven days or less” and therefore the aircraft leasing activity was not a rental activity.

**6. It ain’t over till it’s over.** Herwig v. Commissioner, T.C. Memo. 2014-95 (5/20/14). The taxpayers were partners in a partnership that owned two rental real properties that concededly were passive activities. Prior to 2008 they had passive activity losses, the deductions for which were deferred by § 469. In 2008, the mortgagee bank judicially foreclosed on the properties, which were sold to the mortgagee bank in 2008. The bank’s claim for deficiency judgments and the taxpayer’s counterclaims against the bank were settled in 2011. The taxpayers claimed their suspended passive activity losses under § 469(g) in 2008, claiming that by virtue of the foreclosure they had terminated their entire interest in the activities. The Tax Court (Special Trial Judge Guy) held that the taxpayers had not completely terminated their entire interest in the activities in 2008. Section “469(g) contemplates that the taxpayer must dispose of his or her entire interest in a passive activity in a transaction with an unrelated party under which all gain or loss realized on such disposition is recognized.” Although the bank foreclosed in 2008, the partnership continued to list the properties as assets on its partnership returns for 2009 and 2010, and the bank’s motion for entry of deficiency judgments and the taxpayers’ counterclaim against the bank were pending in the foreclosure litigation until both matters were settled in 2011, when the taxpayers recognized COD income. In light of the uncertainties inherent in the ongoing litigation, the cumulative economic effect of the taxpayers’ investment in the passive activity—“a final accounting of the gain or loss realized on the disposition of the passive activity and recognition of any gain

or loss for tax purposes”—could not be determined in 2008. Thus, they did not dispose of their entire interests in the passive activity within the meaning of § 469(g) as a result of the 2008 foreclosure, and their suspended passive losses were not eligible to be treated as nonpassive losses for that year.

**7. Sky King this guy ain’t.** Williams v. Commissioner, T.C. Memo. 2014-158 (8/5/14). For purposes of § 469, the taxpayer attempted to group under Reg. § 1.469-4(c) an airplane rental activity with a “telephone skills training business” to avoid the application of § 469 to losses incurred with respect to the airplane activity. The Tax Court (Judge Buch) held the grouping to be improper: (1) there were no similarities between the business of renting an airplane and that of telephone sales training; (2) there was no apparent nexus between the businesses; (3) common control and ownership and geographic location were not particularly relevant; (4) although the airplane was housed at two airports close to the telephone skills training business, those locations were convenient to the taxpayer; and (5) there was no interdependence of the activities. The taxpayer’s claim that the activities were interdependent because ownership of the airplane helped avoid “the notorious pat downs and searches and baggage claim and lost baggage with the airlines,” was rejected because the taxpayer would rent another airplane for travel because he could earn more from renting his own airplane to other pilots or pilot trainees than he would pay if he rented another airplane for a trip; most of the airplane’s use and income came from renting it out, which had no effect on the telephone skills training business; and there was no indication that the airplane activity depended on the telephone skills training business, which was only an occasional user of the airplane. There was no evidence that the telephone skills training business and the airplane activity had any of the same customers or that the two activities were integrated in any meaningful way. The taxpayer was unable to establish that he materially participated in the airplane activity separately from the telephone skills training business. The court sustained a 20-percent accuracy related penalty.

### III. INVESTMENT GAIN AND INCOME

#### A. Gains and Losses

**1. Just because you’re a good guy who helps the government recover tens of millions of dollars of fraudulent Medicare claims doesn’t punch your ticket to the promised land of capital gains.** Patrick v. Commissioner, 142 T.C. 124 (2/24/14). The taxpayer filed several *qui tam* complaints under the False Claims Act, alleging that his employer defrauded the government by improperly marketing medical equipment as

requiring in-patient rather than out-patient treatment and that certain medical providers billed treatments under Medicare as in-patient expenses. The cases were settled for over \$75 million and the government intervened. The taxpayer received a relator's share totaling over \$6.8 million, which he reported as capital gain. The IRS treated the relator's awards as ordinary income. The Tax Court (Judge Kroupa) sustained the deficiency, rejecting the taxpayer's argument that the FCA gives rise to a contract under which the relator sells information to the government in exchange for a share of the recovery. First, there was no sale or exchange of information. "The Government does not purchase information from a relator under the FCA. Rather, it permits the person to advance a claim on behalf of the Government. The award is a reward for doing so. No contractual right exists." Second, the information provided to the government was not a capital asset. "The ordinary income doctrine excludes from the definition of a capital asset 'property representing income items or accretions to the value of a capital asset themselves properly attributable to income.'" The taxpayer "did not receive a right to the relator's share in exchange for an underlying investment of capital." The right to income was a reward, which is ordinary income. Finally, the information the taxpayer gave to the government was not a capital asset because it was not property. The information could not be property because the taxpayer did not have a legal right to exclude others from its use and enjoyment. The False Claims Act obligated him to turn over all supporting documentation to the government, and the taxpayer had no right to prevent his employer or medical providers from using or disclosing the information.

**2. "Bitcoin is not a currency." "No surprise" says Professor Omri Marian.**<sup>1</sup> Notice 2014-21, 2014-16 I.R.B. 938 (3/25/14). This notice "describes how existing general tax principles apply to transactions using virtual currency." The notice has two main components: (1) a substantive part (i.e., how Bitcoin transactions should be taxed), and (2) an information reporting part (i.e., how income on Bitcoin transactions should be reported and how tax can be collected).

*Substance.* The substantive part of the Notice provides very few surprises. The most important conclusions are as follows.

(1) Bitcoin is *not* a currency for tax

---

1. This discussion of Notice 2014-21 is adapted, with permission, from a TaxProf Blog op-ed by Omri Y. Marian, Assistant Professor of Law, University of Florida Levin College of Law, on March 26, 2014, available at [http://taxprof.typepad.com/taxprof\\_blog/2014/03/marian-bitcoin.html](http://taxprof.typepad.com/taxprof_blog/2014/03/marian-bitcoin.html). We thank Prof. Marian for granting us permission to include his work in this outline. *See also* Omri Y. Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38 (2013).

purposes; it is property. As such, gain and losses on the disposition of Bitcoins can never be “exchange gain or loss.” I.R.C. § 988. This may come as a disappointment to taxpayers who lost money in Bitcoin investments and may have hoped to have the losses classified as exchange-losses, and, as such, as ordinary losses. On the other hand, taxpayers who have disposed of appreciated investment positions in Bitcoins may enjoy capital gains treatment. Taxpayers who hold Bitcoin as inventory will be subject to ordinary gains and losses upon disposition.

(2) The receipt of Bitcoins in exchange for goods and services is taxable at the time of receipt. The amount realized is the U.S. dollar value of the Bitcoins received. The disposition of Bitcoins in exchange for goods and services is a realization and recognition event to the extent the value of Bitcoin has changed since the time it was acquired. Thus, if a taxpayer bought one Bitcoin for \$500, and later used one Bitcoin to purchase a TV when Bitcoin was trading at \$600, the taxpayer has a taxable gain of \$100.

This part of the Notice has attracted some criticism from several commentators. A New York Times article summarized this critique, noting that characterizing Bitcoin as property could discourage the use of Bitcoin as a payment method. If a user buys a product or service with Bitcoin, for example, the IRS will expect the individual to calculate the change in value from the date the user acquired a Bitcoin to the date it was spent. That would give the person a basis to calculate the gains—or losses—on what the IRS is now calling property.

- This criticism is partially justified, although the result would have generally been the same had the IRS decided to classify Bitcoin as a foreign currency. Under current law, U.S. taxpayers whose functional currency is the U.S. dollar (practically all U.S. taxpayers), must track their basis in any foreign currency they hold, and recognize exchange gain or loss as soon as they dispose of the currency, but only to the extent their exchange gain or loss exceeds \$200. Thus, the criticism might have some merit, as capital gains or losses are taxed from the first dollar, while exchange gain or losses are subject to the \$200 threshold. I.R.C. § 988(e). This could be corrected if a de minimis threshold would be made applicable to Bitcoin transactions as well, but it is not clear that there is any legal basis for the IRS to do so. The only way to completely avoid taxation upon disposition of Bitcoin is to characterize it as a functional currency, which could only conceivably happen if the U.S. adopts Bitcoin as a legal tender. This is much to ask for and certainly not within the power of the IRS to decide.

(3) Since taxes are paid in U.S. Dollars and not in Bitcoins, the Bitcoin value must be converted to U.S. dollars for purposes of determining gains and losses. Fair market value is determined by reference to the BTC/USD price quoted in an online exchange if “the exchange

rate is established by market supply and demand.” The problem with this determination is that there are multiple such exchanges, and the BTC/USD spot price may vary significantly among such exchanges. In March, 2013, the price difference between various exchanges varied by as much as \$100, for an average trading price across exchanges of about \$575. Taxpayers could cherry-pick their BTC/USD exchange rate and reduce tax gains or increase tax losses. The Notice prescribes that BTC to USD conversion must be made “in a reasonable manner that is consistently applied.” It is not clear what “consistency” means in this context and more guidance on this issue is needed.

(4) Mined Bitcoins are includable in gross income, and thus taxed, upon receipt. Bitcoins come into existence by a mining process. “Miners” use their computing resources to validate Bitcoin transactions, and in return are compensated with newly created Bitcoin. Unsurprisingly, the IRS concluded that such income is taxable upon receipt.

- The IRS did not explicitly rule on the character of mining income, but it is most likely ordinary, under several possible theories. First, it is income from services—miners are paid in newly generated Bitcoin for handling the bookkeeping of the Bitcoin public ledger. The IRS describes mining income as income received from using “computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger.” This may imply that the IRS views mining income as income from the provision of services. Second, it is wagering income—from a technical point of view mining is guessing the correct answer to a complex cryptographing problem. Third, mining pools—most miners mine through mining pools, where multiple individual miners pool together their computing resources in order to generate Bitcoins. Mining pools might be classified as partnerships for tax purposes. If the mining pool is a partnership, the mining pool itself is clearly in the business of mining Bitcoins. Any income from a trade or business of the partnership (the pool) passes through as ordinary income to the partners (the miners). If the mining pool is not a partnership, miners essentially rent out their computing capacity to the mining pool’s operator. Rental income is ordinary income.

*Information reporting and backup withholding.* The Notice, as expected, also concludes that payments in Bitcoins are subject to information reporting and backup withholding. Thus, a person who in the course of trade or business makes Bitcoin payments in excess of \$600 to a non-exempt U.S. person, must report such payments to the IRS and to the recipient on the applicable Form 1099. The payments are also subject to backup withholding to the extent the payor is unable to solicit the requisite tax information from the payee.

- This interpretation is perfectly reasonable, but its practical significance is left to be seen. The U.S. information reporting system is built, among others, on the assumption that parties to a taxable transaction know each other (or can reasonably obtain information about one another and send

information to each other). As such, for example, taxpayers can send Forms 1099 to each other. The operation of Bitcoin defeats this assumption. Bitcoin is specifically designed to allow for exchange of value without having the parties to a transaction ever know each other. In fact, a Bitcoin payor is not always in a position to know whether payments he or she makes are made to the same person, or to different people. Payors may have a hard time even deciding whether the \$600 threshold is met. The default is backup withholding. It is not clear, however, how the IRS can enforce reporting and withholding requirements when both parties to a transaction are anonymous both to the IRS and to each other. The ramifications may be significant. Consider, for example, mining pools. In order to be in compliance, U.S.-based mining pools would have to identify their participants by name (rather than by anonymous address), a result that the Bitcoin community is all but certain to dislike. The alternative—backup withholding by the pool operator in respect of the Bitcoin mined—would probably drive Bitcoin miners to mining pools operated by non-U.S. taxpayers. It will be interesting to see how these requirements pan out.

*Unaddressed issues.* The IRS is well aware of the limited breadth of the Notice and it has solicited comments from taxpayers. Some specific issues not addressed by the Notice that may be of significance are as follows: (1) Whether Bitcoin and Bitcoin-wallets are financial assets and financial accounts, respectively, for purposes of FATCA and FBAR reporting requirements. This may not be of immediate relevance to most taxpayers due to the dollar amount thresholds applicable in such contexts, but as Bitcoin grows in popularity, such issues may become relevant. (2) Whether Bitcoin service providers (such as wallet service providers, Bitcoin exchanges, Bitcoin mining pools and so on) are financial institutions for reporting, withholding, and FATCA purposes. (3) Whether Bitcoin mining pools are entities for tax purposes. Some Bitcoin mining pools may conceivably be classified as entities separate from their owners for tax purposes, and as such may qualify as partnerships. This may carry with it significant tax consequences to Bitcoin miners. (4) Can Bitcoin be classified as a commodity for purposes of § 475(e), allowing dealers to elect mark-to-market accounting?

*Summary.* The IRS guidance is clear, concise, and correct on the law. While some obscurities remain, most major interpretative issues are addressed. The Notice does an excellent job explaining how transactions involving Bitcoin are taxed. It got all of the substantive issues right. In the context of information reporting, however, the Notice exposes the limitations of current tax law when it comes to collecting tax on Bitcoin transactions. While the IRS got the information reporting part right as well, the practical ability of the IRS to enforce such requirements may be limited in certain contexts. The main challenge remains in the area of collection. Time will tell whether the arsenal at the disposal of the IRS is enough to deal with tax evasion through Bitcoin, or whether Congress will have to supply the IRS with additional ammo.

**a. Are virtual currency accounts reportable on the FBAR?** In an IRS webinar broadcast on 6/4/14 (available at <http://www.irsvideos.gov/ElectronicFBAR/>), a senior program analyst in the Small Business/Self Employed Division stated that the IRS and the Financial Crimes Enforcement Network (FinCen) have “been closely monitoring developments around virtual currencies” such as Bitcoin. However, “for right now, FinCen has said that virtual currency is not going to be reportable on the FBAR, at least for this filing season. That could change in the future, as we monitor what’s happening with virtual currencies . . . .” *See also Virtual Currency May Be Reportable on FBAR in Future*, 2014 TAX NOTES TODAY 108-2 (6/5/14).

**3. In complex transactions involving securities and money market mutual fund shares, the taxpayer was not required to show an “actual economic loss” to deduct losses, but was required to allocate basis between income interests and residual interests to calculate gain or loss on the interests sold.** Principal Life Insurance Co. v. United States, 116 Fed. Cl. 82 (5/9/14). The taxpayer engaged in two types of transactions. First, the taxpayer purchased residual interests in money market mutual fund shares from six separate sellers in eight separate transactions. In each transaction, the selling financial institution retained a carved-out income interest in the underlying money market shares, which constituted all dividends paid in connection with the money market shares for a period of between 20 and 23 years. The transaction was actually more complex and both the taxpayer and the sellers held their beneficial interests through trusts. In the second set of transactions, the taxpayer purchased a portfolio of eight to ten perpetual floating-rate securities from third parties in the secondary market and sold the residual interests, while retaining carved-out income interests. It transferred the residual interests to a trust and allocated all of its tax basis in each underlying perpetual security to the corresponding Principal Certificate—even though the Interest Certificate reflected 80 percent of the cost of the overall security. The taxpayer then claimed a loss on the sale of the residual interests. The IRS disallowed the loss on the second set of transactions and included in the taxpayer’s income the current interest income on the first set of transactions. The taxpayer paid and pursued a refund. The Court of Claims (Judge Allegra) granted the government’s motion for partial summary judgment and denied the taxpayer’s claim, although it rejected the government’s argument that the loss was disallowed because § 165(a) “requires that there be an ‘actual economic loss’ before a deduction is permitted,” rejecting the government’s reasoning that such was the import of Reg. § 1.165-1(b), which states that “[o]nly a bona fide loss is allowable.” Instead, the court held that the basis apportionment rule of Reg. § 1.61-6(a) applied to allocate basis between the retained income interests and the

transferred residual interests, rejecting the taxpayer's argument that case law provided an exception to Reg. § 1.61-6(a) for carved out income interests. Because the loss deduction was based upon a basis allocation that was erroneous as a matter of law, and since the taxpayer offered no alternative to its failed argument, summary judgment for the government was entered on the loss issue. Alternatively, the loss was disallowed on the ground that the complex transaction—which defies a summary description—by which the residual interests were transferred to the trust was a transfer to a partnership (relying on Reg. § 301.7701-4(c)(1), dealing with investment “trusts” in which there is a power to vary the interests of the beneficial owners) in exchange for a partnership interest to which § 721 applied. As for the first set of transactions, the court again found the trusts actually to be partnerships under Reg. § 301.7701-4(c)(1) and that a portion of the partnership income should have been allocated to the taxpayer as a partner. Although the return position was erroneous, factual issues remained for trial.

- The opinion did not discuss the possible applicability of § 1286(b)(3) to require basis apportionment.

**4. You can't have your cake and eat it too!** Debough v. Commissioner, 142 T.C. No. 17 (5/19/14). This case involves the interplay between §§ 121 and 1038, which provides rules for computing gain when a seller repossesses real property in satisfaction of a debt secured by that real property. The taxpayer and his wife sold their primary residence in 2006 pursuant to an installment sale agreement. The buyers' debt was secured by a mortgage on the home. The price was \$1,400,000 and the taxpayers recognized a gain of \$657,796. The taxpayers properly excluded \$500,000 in gain on the sale. They calculated the gain reportable in each year by (1) excluding \$500,000 of gain pursuant to § 121, (2) calculating their gross profit percentage by dividing the \$157,796 in remaining gain (\$657,796–\$500,000 = \$157,796) by the \$1,400,000 sale price exclusive of commissions and other costs of sale, and (3) multiplying the gross profit percentage by the amount of money received. In total, the taxpayer (his wife having died in 2006) received payments of \$505,000 and reported \$56,920 in gain over the course of 2006, 2007, and 2008. In 2009, the buyers defaulted and the taxpayer reacquired the property. He treated his reacquisition of the property in 2009 as a reacquisition of property in full satisfaction of indebtedness under § 1038 and recognized \$97,153 in the form of long-term capital gains related to the reacquisition of the property. The IRS asserted that the long-term capital gain the taxpayer was required to recognize on the reacquisition of the property included the \$500,000 that he had previously excluded under § 121. The Tax Court (Judge Nega) agreed with the IRS, holding that the gain recognized on the reacquisition of the property included gain previously excluded under § 121. Generally speaking, under § 1038, if the seller of real property receives the

buyer's purchase money debt obligation and the seller reacquires the property in partial or full satisfaction of the buyer's debt, the seller does not recognize gain or loss upon the reacquisition, except, as provided in § 1038(b), to the extent he has received money or other property that exceeds the amount of gain reported before the reacquisition. (The special exception to the general rule in § 1038(e) was inapplicable because the taxpayer had not resold the residence within one year after its reacquisition.) Because the taxpayer had received \$505,000 in cash before the reacquisition and had both the cash and the house as a result of the reacquisition, he was "actually in a better position than he was before the sale by virtue of having ownership over both the property and \$505,000."

**5. There is no unconditional "one bite" at capital gains rule.** *Allen v. United States*, 113 A.F.T.R.2d 2014-2262 (N.D. Cal. 5/28/14). The taxpayer was a full-time civil engineer who worked primarily for developers. As a one-time venture, he purchased 2.63 acres of undeveloped land that he admitted he tried, unsuccessfully, to develop between 1987 and 1995. In 1998, when he had been unable to develop the property, he sold the land for (1) a lump-sum payment and (2)(a) 22 percent of the buyer's profits plus (b) a set fee whenever the purchaser sold a developed unit. On a motion for summary judgment, the District Court (Judge Orrick) held that the taxpayer's gains were ordinary income, not capital gain. First, the taxpayer at all times intended to develop the property and undertook substantial efforts to do so; there were no specific facts to support the taxpayer's declaration that prior to the sale his purpose in holding the property changed from development to "investment." The court rejected the taxpayer's argument that he was entitled to "one bite" at capital gains, citing *Cottle v. Commissioner*, 89 T.C. 467 (1987).

**6. What! You mean my money market fund might lose money—an exception from the wash sale rules for money market fund losses.** Rev. Proc. 2014-45, 2014-34 I.R.B. 388 (7/23/14). This revenue procedure (proposed as a de minimis rule in Notice 2013-48, 2013-31 I.R.B. 120 (7/3/13)) provides a complete exception to the § 1091 wash sale rules for certain redemptions of shares of money market funds (MMFs) that, under SEC regulations, do not maintain a constant share price. It applies to a redemption of one or more shares in an investment company registered under the 1940 Act if: (1) the investment company is regulated as an MMF under SEC Rule 2a-7 and holds itself out to investors as an MMF; and (2) at the time of the

redemption, the investment company is a floating-NAV<sup>2</sup> MMF. If a redemption of shares in an MMF to which the revenue ruling applies results in a loss, the IRS will not treat the redemption as part of a wash sale. Section 1091(a) will not disallow the deduction for the resulting loss in the year realized and § 1091(d) will not cause the basis of any property to be determined by reference to the basis of the redeemed shares. In the revenue procedure previously proposed in Notice 2013-48, a loss was not subject to the wash sale rules if a taxpayer realized a loss upon a redemption of shares in a floating-NAV MMF and the amount of the loss was not more than 0.5 percent of the taxpayer's basis in the shares; in contrast, this revenue procedure completely exempts floating-NAV MMFs from the wash sale rules of § 1091.

**a. A simplified method of accounting for gains and losses in shares of money market funds that do not maintain a constant share price.** REG-107012-14, Method of Accounting for Gains and Losses on Shares in Certain Money Market Funds; Broker Returns With Respect to Sales of Shares in Money Market Funds, 79 Fed. Reg. 43694 (7/28/14). These proposed regulations provide a simplified method of accounting for gains and losses on shares of floating-NAV MMFs. Under this method, gain or loss is based on the change in the aggregate value of the shares in the floating-NAV MMF during a computation period (which may be the taxpayer's taxable year or certain shorter periods) and the net amount of the purchases and redemptions during the period. For example, if the MMF shares held by a calendar-year individual have a value of \$1 million on January 1, a closing value on December 31 of \$1.1 million, and if during the year the taxpayer purchases additional shares for \$50,000 and has shares redeemed for \$40,000, the taxpayer's gain for the year would be \$90,000 (\$100,000 change in value minus \$10,000 net amount of purchases and redemptions). The character of the taxpayer's gain or loss depends on the character of the underlying MMF shares in the taxpayer's hands. The simplified method of accounting does not change the tax treatment of dividends received. A taxpayer that adopts the simplified method of accounting will not need to take advantage of the exception from the wash sale rules provided in Rev. Proc. 2014-45, 2014-34 I.R.B. 388 (7/23/14), because under the simplified method net gain or loss is determined for each computation period, and no gain or loss is determined for any particular redemption of a taxpayer's shares in a floating-NAV MMF. Once a taxpayer has adopted a method of accounting for gains and losses on shares in floating-NAV MMFs, any change from that method (including a change to or from the simplified method) is a change in method

---

2. An MMF that uses market factors to value its securities and uses basis point rounding to price its shares for purposes of distribution, redemption, and repurchase.

of accounting to which the provisions of § 446 and the accompanying regulations apply. The proposed regulations concerning the simplified method are proposed to apply to taxable years ending on or after the date final regulations are published in the Federal Register, but shareholders of floating-NAV MMFs can rely on the proposed regulations for taxable years ending on or after 7/28/14 and beginning before the date final regulations are published in the Federal Register.

**7. “A ‘transferor’s acts . . . speak louder than his words in establishing whether a sale of a patent has occurred.’”** Cooper v. Commissioner, 143 T.C. No. 10 (9/23/14). The taxpayer was an engineer-inventor who transferred several patents to a corporation in which he owned 24 percent of the stock. His wife’s sister and a friend owned the remaining stock. The corporation and its shareholders entered into a stock restriction agreement providing that shares could not be sold, assigned, or transferred except according to the terms of the stock restriction agreement. Under the agreement, the taxpayer was permitted to transfer shares to his issue or any trust for their benefit. The two other shareholders were permitted to transfer shares only to another shareholder. In consideration of the transfer, the taxpayer received a royalty, and he claimed that the royalty receipts were entitled to capital gain treatment under § 1235. Section 1235(a) provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent by any holder will be treated as the sale or exchange of a capital asset held for more than one year, regardless of whether the payments in consideration of such transfer are contingent on the productivity, use, or disposition of the property transferred. Based on the record, the Tax Court (Judge Marvel) found that substantially all of the corporation’s decisions regarding licensing, patent infringement, and patent transfers were made either by the taxpayer or at his direction. The taxpayer controlled the corporation in all material respects. The other two shareholders acted in their capacities as directors and officers at the taxpayer’s direction. They did not make independent decisions in accordance with their fiduciary duties or act in their best interests as shareholders. The court upheld the IRS’s treatment of the royalty as ordinary income, even though § 1235(d) did not apply to deny capital gain treatment. (Under § 1235(d), transfers between related persons, as defined in § 267(b), are not eligible for capital gain treatment, and for purposes of § 1235, a corporation and an individual owning 25 percent or more of the stock of such corporation directly or indirectly are related persons.) Neither the Code nor regulations address whether § 1235 “applies to transfers to a corporation that is not related to the holder but is indirectly controlled by the holder,” and “[w]hether a holder’s control over a corporate transferee that is unrelated (within the meaning of section 1235(d)) defeats capital gain treatment” was an issue of first impression for the Tax Court. However,

*Charlson v. United States*, 525 F.2d 1046 (Ct. Cl. 1975), considered this issue and concluded that such control could prohibit the transfer of substantially all rights in a patent and therefore precluded capital gain treatment under § 1235. The Tax Court agreed with the holding of *Charlson*, “that retention of control places the holder in essentially the same position as if the patent had not been transferred, thereby precluding the application of section 1235,” and “that Congress intended for a ‘transferor’s acts to speak louder than his words in establishing whether a sale of a patent has occurred.’” Accordingly, it held that “retention of control by a holder over an unrelated corporation can defeat capital gain treatment under section 1235 because the retention prevents the transfer of ‘all substantial rights’ in the patent.” Analyzing the record, the court concluded that the corporation was not independent of the taxpayer, and thus the taxpayer had not transferred all substantial rights in the patents to the corporation as required to obtain capital gain treatment under § 1235(a).

- With respect to other issues in the case, the taxpayer was denied a bad debt deduction for a debt from another corporation from which he had made no reasonable attempt to collect the debt and with respect to which he did not identify specific events “that made recovery of the debt futile in the future.” But he secured a minor victory in being allowed to deduct certain professional engineering fees that he paid in an attempt to determine how certain products were designed and manufactured and whether any of the products infringed on his patents. The court rejected the IRS’s argument that the expenses properly were expenses of one or the other of two corporations. Rather, the court concluded, the expenditures “were proximately related to Mr. Cooper’s business as an inventor and their payment by him was ordinary and necessary.”

- Section 6662 accuracy related penalties were upheld with respect to both the bad debt deduction and the taxpayer’s treatment of the royalties as capital gain. The taxpayer claimed a good faith reliance defense based on the advice of a tax lawyer with respect to the royalties. The lawyer testified that he advised the taxpayer that he could not indirectly control the corporation. Moreover, he did not provide the advice before the taxpayer filed his tax return and did not provide advice regarding whether the taxpayer controlled the corporation. The taxpayer did not follow the lawyer’s advice to ensure that he did not indirectly control the corporation. Consequently, the taxpayer could not claim reliance on professional advice to negate the penalty with respect to the erroneous capital gain treatment of the royalty payments.

**8. It’s alchemy—a frustrated intent to earn ordinary income magically turns into capital gain.** *Long v. Commissioner*, 772 F.3d 670 (11th Cir. 11/20/14), *aff’g in part and rev’g in part*, T.C. Memo 2013-233. The taxpayer owned the stock of a corporation (LOTC), which had the right to purchase land from another party under a purchase and sale agreement.

The taxpayer, through his corporation, planned to build a condominium on the land. The seller refused to perform, and LOTC sued the seller and obtained a court order for specific performance. Rather than LOTC purchasing the property, the taxpayer (not LOTC) “sold his position as plaintiff” in the suit for \$5,750,000. (The IRS and the taxpayer stipulated that notwithstanding the interposition of LOTC, which had no employees, no TIN, and never filed a tax return, the taxpayer was at all times acting as an unincorporated sole proprietor.) The Tax Court held that the proceeds of the sale of the contract were ordinary income, but the Eleventh Circuit reversed on this issue, holding that the proceeds were capital gain. According to the Court of Appeals, the Tax Court erred by treating the land itself, which the taxpayer intended to develop and sell in the ordinary course of business, as the property that the taxpayer sold (which is indeed what the Tax Court did), when it was clear that he “did not sell the land itself, but rather his right to purchase the land, which is a distinct contractual right that may be a capital asset.” Thus, “[t]he dispositive inquiry [was] not ‘whether Long intended to sell the land to customers in the ordinary course of his business,’ but whether Long held the exclusive right to purchase the property ‘primarily for sale to customers in the ordinary course of his trade or business.’” Because there was no evidence that the taxpayer had any “intent to assign his contractual rights in the ordinary course of business,” or to obtain the judgment for the purpose of selling it in ordinary course of business, the gain was capital gain. Furthermore, the gain was long term capital-gain because the “property” that was sold was the right to purchase the land, which originally arose from the purchase contract, not the state court judgment in the specific performance suit. Finally, the court rejected the IRS’s argument that the sales proceeds were ordinary income under the “substitute for ordinary income” doctrine. The court reasoned as follows:

It cannot be said that the profit Long received from selling the right to attempt to finish developing a large residential project that was far from complete was a substitute for what he would have received had he completed the project himself. Long did not have a future right to income that he already earned. By selling his position in the litigation, Long effectively sold Ferris his right to finish the project and earn the income that Long had hoped to earn when he started the project years prior. Taxing the sale of a right to create—and thereby profit—at the highest rate would discourage many transfers of property that are beneficial to economic development.

Long possessed a “bundle of rights [that] reflected something more than an opportunity...to obtain periodic receipts of income.” *Comm’r v. Ferrer*, 304 F.2d 125, 130–31 (2d Cir.1962) ... . Long’s profit was not “simply the amount [he] would have received eventually, discounted to present value.” *Womack*, 510 F.3d at 1301. Rather, Long’s rights in the LORH property represented the potential to earn income in the future based on the owner’s actions in using it, not entitlement to the income merely by owning the property. ... We have already held that selling a right to earn future undetermined income, as opposed to selling a right to earned income, is a critical feature of a capital asset. *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 59 (5th Cir. 1963). The fact that the income earned from developing the project would otherwise be considered ordinary income is immaterial.

(The Court of Appeals affirmed the Tax Court’s holdings on other issues.)

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

**B. Interest, Dividends, and Other Current Income**

There were no significant developments regarding this topic during 2014.

**C. Profit-Seeking Individual Deductions**

There were no significant developments regarding this topic during 2014.

**D. Section 121**

There were no significant developments regarding this topic during 2014.

**E. Section 1031**

**1. Keeping things all in the family was a meathead move in an attempted deferred like-kind exchange.** Blangiardo v. Commissioner, T.C. Memo. 2014-110 (6/9/14). The taxpayer attempted a deferred like-kind exchange using his lawyer-son as an intermediary. The Tax Court (Judge Jacobs) granted summary judgment for the IRS that the exchange did not qualify under § 1031. Reg. § 1.1031(k)-1(g) provides a safe harbor for the use of a “qualified intermediary,” but pursuant to Regs. §§ 1.1031(k)-1(g)(4)(iii)(A) and 1.1031(k)-1(k)(3), the taxpayer’s son was not a qualified intermediary because the taxpayer and his son were related as defined in § 267(b). It was not relevant that: (1) the son was an attorney; (2) the funds from the sale of the relinquished property were held in an attorney trust account; and (3) the real estate documents referred to the transaction as a § 1031 exchange.

**F. Section 1033**

**1. “How dry I am.”** Notice 2014–60, 2014-43 I.R.B. 741 (9/30/14). This notice contains a list of the counties that experienced exceptional, extreme, or severe drought during the preceding 12-month period ending August 31, 2014, which triggers the 4-year replacement period under § 1033(e)(2) for livestock sold on account of drought. A lot of counties in a lot of states make the list.

### G. Section 1035

There were no significant developments regarding this topic during 2014.

### H. Miscellaneous

There were no significant developments regarding this topic during 2014.

## IV. COMPENSATION ISSUES

### A. Fringe Benefits

1. **“White House suspends [individual] mandate penalty for those with cancelled health plans.”** Individuals whose health insurance plans were cancelled by insurers because they did not meet the requirements of the Affordable Care Act will be eligible for an exemption from the individual mandate penalty under § 5000A that takes effect in 2014, the Department of Health and Human Services said late December 19. *White House Suspends Mandate Penalty for Those With Canceled Health Plans*, 2013 TAX NOTES TODAY 246-5 (12/23/13). The mandate requires everyone to have health insurance or face a tax penalty, the greater of \$95 or 1 percent of income in 2014. The administration will also allow those consumers to sign up for catastrophic coverage. Those bare-bones plans are available to people who are under 30 or qualify for a “hardship exemption.” HHS Secretary Kathleen Sebelius said in a letter to Sen. Mark Warner, D-Va., that the administration is granting a “hardship exemption” to Americans whose plans were canceled and “might be having difficulty” paying for standard coverage.

a. **Based on the Religious Freedom Restoration Act, the Supreme Court strikes down the application of Obamacare’s contraceptive mandate to closely held businesses owned by persons who claim their Christian beliefs would be violated by compliance with that mandate** *Burwell v. Hobby Lobby Stores, Inc.*, 134 S. Ct. 2751 (6/30/14) (5-4), *aff’g Hobby Lobby Stores, Inc. v. Sibelius*, 723 F.3d 1114 (10th Cir. 6/27/13) (en banc). Justice Alito’s majority opinion was based upon the Religious Freedom Restoration Act, which requires that requirements of general applicability that substantially burden a person’s exercise of religion must: (1) be in furtherance of a compelling governmental interest, and (2) be

the least restrictive means of furthering that compelling governmental interest. The other four male Catholic justices joined in this opinion.

- Justice Ginsburg dissented on the grounds that (1) having to pay for abortifacients does not affect the owners' exercise of their religion, and (2) commercial enterprises operating in corporate form do not have religious rights. Justice Sotomayor joined in the dissenting opinion, and Justices Breyer and Kagan joined as to the first ground but not the second.

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

**a. The obvious solution has a great big catch in it.** In a Q&A issued on 5/13/14, available on the IRS's web site (<http://www.irs.gov/uac/Newsroom/Employer-Health-Care-Arrangements>), the IRS states:

Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a

qualified health plan in the Marketplace or outside the Marketplace)?

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

**3. Guidance on the Affordable Care Act's employer shared responsibility payment.** T.D. 9655, Shared Responsibility for Employers Regarding Health Coverage, 79 F.R. 8544 (2/12/14). Section 4980H was enacted by the Patient Protection and Affordable Care Act and amended by the Health Care and Education Reconciliation Act of 2010 and the Department of Defense and Full-Year Continuing Appropriations Act of 2011. Under § 4980H, an applicable large employer is subject to an assessable payment for a month if a full-time employee enrolls for that month through a health insurance exchange in a qualified health plan for which the employee receives a premium tax credit and the employer either fails to offer its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan or offers coverage that is not affordable or does not provide minimum value. The IRS and Treasury have promulgated Regs. §§ 54.4980H-0 through 54.4980H-6 providing comprehensive guidance regarding the § 4980H assessable payment, commonly known as the "employer shared responsibility payment." The regulations provide extensive guidance on determining an employer's status as an "applicable large employer," which is defined by statute as an employer that "employed an average of at least 50 full-time employees on business days during the

preceding calendar year.” The regulations generally are effective 2/12/14 and are applicable for periods after 12/31/14.

- The preamble to the regulations extends previously granted transition relief. Although § 4980H applies to months beginning after 12/31/13, the IRS announced in Notice 2013-45, 2013-31 I.R.B. 116 (7/29/13), that no employer shared responsibility payments would be assessed for 2014. The preamble to the regulations extends this relief through 2015 for applicable large employers that employ fewer than 100 full-time employees. (This transition relief is not available, however, to employers that reduce the size of their workforce or the overall hours of service of their employees in order to fall below the 100 full-time employee threshold.) Thus, in 2015, only employers that employ 100 or more full-time employees are subject to the shared responsibility payment. Further, in 2015, an applicable large employer that offers coverage for a month to at least 70 percent of its full-time employees (and, to the extent required, their dependents) will be treated as offering coverage for that month to its full-time employees (and dependents). The effect of this rule is that, if the coverage offered is affordable coverage and provides minimum value, the employer will not be subject to an assessable payment under § 4980H. The required percentage of full-time employees to whom coverage must be offered increases to 95 percent in 2016.

- See also Treasury and IRS Issue Final Regulations Implementing Employer Shared Responsibility Under the Affordable Care Act for 2015, 2014 TAX NOTES TODAY 28-21 (2/10/14).

**4. Providers of minimum essential health coverage and employers subject to the Affordable Care Act’s shared responsibility payment must submit information returns for 2015 and are encouraged to submit returns for 2014.** T.D. 9660, Information Reporting of Minimum Essential Coverage, 79 F.R. 13220 (3/10/14); T.D. 9661, Information Reporting by Applicable Large Employers on Health Insurance Coverage Offered Under Employer-Sponsored Plans, 79 F.R. 13231 (3/10/14). Sections 6055 and 6056 were added to the Code by the Patient Protection and Affordable Care Act. Section 6055 requires annual information reporting by health insurance issuers, self-insuring employers, government agencies, and other providers of health coverage and requires the provider to furnish a related statement to each individual whose information is reported. Section 6056 requires annual information reporting by applicable large employers relating to the health insurance that the employer offers (or does not offer) to its full-time employees and requires the employer to furnish related statements to employees that employees may use to determine whether, for each month of the calendar year, they may claim on their individual tax returns a premium tax credit under § 36B. The IRS and Treasury have issued final regulations implementing these reporting requirements. The required

statements generally must be furnished to individuals or employees for a calendar year on or before January 31 of the succeeding year, and the information returns for a calendar year generally must be filed on or before February 28 of the succeeding year (March 31 if filed electronically). The regulations generally apply for calendar years beginning after 12/31/14.

- Although §§ 6055 and 6056 apply to months beginning after 12/31/13, the IRS announced in Notice 2013-45, 2013-31 I.R.B. 116 (7/29/13), that reporting is not required with respect to 2014. Reporting for 2014 is optional and no penalties will be applied for failure to comply with the information reporting provisions for 2014. Accordingly, the first year for which reporting is required is 2015. (All applicable large employers, including those that are not subject to the shared responsibility payment of § 4980H for 2015 because they have fewer than 100 full-time employees, must report for 2015.) This reporting will take place in early 2016. Nevertheless, providers and employers subject to the information reporting requirements are encouraged to voluntarily comply with the information reporting provisions for 2014.

- Most employers that sponsor self-insured group health plans are applicable large employers that are required to report under both § 6056 and § 6055. The regulations provide that such applicable large employers will file a single information return that combines reporting under §§ 6055 and 6056.

- See also FACT SHEET: Final Regulations Implementing Information Reporting for Employers and Insurers under the Affordable Care Act (ACA), 2014 TAX NOTES TODAY 44-30 (3/5/14).

**5. Although married taxpayers must file a joint return to be eligible for the § 36B premium tax credit, married taxpayers who cannot file a joint return because they are victims of domestic abuse can still be eligible for the credit.** Notice 2014-23, 2014-16 I.R.B. 942 (3/26/14). Beginning in 2014, individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through an Affordable Insurance Exchange are allowed a premium tax credit under § 36B. One eligibility requirement is that individuals must file a joint return if married within the meaning of § 7703. *See* I.R.C. § 36B(c)(1)(C). Married individuals who live apart can be treated as not married if they meet the requirements of § 7703(b), but victims of domestic abuse might not meet those requirements. Accordingly, absent relief, victims of domestic abuse who are married and do not file a joint return for reasons related to the abuse (e.g., risk of injury arising from contacting the other spouse or a restraining order that prohibits contact with the other spouse) would be precluded from claiming the premium tax credit. The preamble to the final regulations issued under § 36B (T.D. 9590,

77 F.R. 30377 (5/23/12)) provided that Treasury and the IRS would propose regulations addressing domestic abuse and similar circumstances that create obstacles to filing a joint return. These proposed regulations have not yet been issued. The notice provides that, for calendar year 2014, a married taxpayer will satisfy the joint filing requirement of § 36B(c)(1)(C) if he or she uses a filing status of married filing separately and meets three requirements: (1) at the time the individual files the return, the individual lives apart from his or her spouse; (2) the individual is unable to file a joint return because he or she is a victim of domestic abuse; and (3) the individual indicates on the return in accordance with instructions that he or she meets the first two requirements.

**6. Final regulations on the Affordable Care Act's requirement that health insurance exchanges report information related to the § 36B premium tax credit.** T.D. 9663, Information Reporting for Affordable Insurance Exchanges, 79 F.R. 26113 (5/7/14). An individual who enrolls in coverage through a health insurance exchange can seek advance payment of the premium tax credit authorized by § 36B. The exchange makes an advance determination of eligibility for the credit and, if approved, the credit is paid monthly to the health insurance issuer. An individual who receives advance credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year. Health insurance exchanges are required by § 36B(f)(3) to report to the IRS and to taxpayers certain information required to reconcile the premium tax credit with advance credit payments and to administer the premium tax credit generally. The IRS and Treasury have issued final regulations implementing this reporting requirement. A health insurance exchange must annually report to the IRS and furnish statements to individuals by January 31 of the year following the calendar year of coverage. In addition, an exchange must report monthly to the IRS on or before the 15th day following each month of coverage. The initial monthly report will be due on a date to be established by the IRS, but no earlier than June 15, 2014. The regulations generally apply for taxable years ending after 12/31/13.

**7. Thousands of dollars of tax breaks for buying luxury cars, pennies for taking the bus.** TIPA retroactively extended through 12/31/14 the one year parity provision requiring that the monthly dollar limitation for transit passes and transportation in a commuter highway vehicle under § 132(f)(2) be applied as if it were the same as the dollar limitation for that month for employer-provided parking. Thus, for 2014, it increases the monthly exclusion for employer-provided transit and van-pool

benefits to \$250—the amount of the maximum exclusion for employer-provided parking benefits.

## **B. Qualified Deferred Compensation Plans**

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

**2. “Roll me over . . . And do it again.”** Rev. Rul. 2014-9, 2014-17 I.R.B. 975 (4/3/14). This revenue ruling presents two situations where the administrator of a qualified plan may reasonably conclude that a potential rollover contribution from another plan, or from an IRA, is a valid rollover contribution under Reg. § 1.401(a)(31)-1, Q&A-14(b)(2).

**3. How does the IRS spell relief for plan administrators who fail to timely file Form 5500-EZ for plans not subject to Title I of ERISA, i.e., one-participant plans and certain foreign plans?** Rev. Proc. 2014-32, 2014-23 I.R.B. 1073 (5/9/14). This revenue procedure spells out the requirements for, and the details of, a pilot program that is effective between 6/2/14 and 6/2/15. The submission must be made on “a signed, filled-out paper version of the applicable Form 5500 Series return [including all schedules] for the specific plan year that is delinquent.”

**4. A payment from a qualified plan for an accident or health insurance premium generally constitutes a distribution under § 402(a) that is taxable to the distributee under § 72.** T.D. 9665, Tax Treatment of Qualified Retirement Plan Payment of Accident or Health Insurance Premiums, 79 F.R. 26838 (5/12/14). These final regulations under § 402(a) clarify the rules on the tax treatment of payments by qualified retirement plans for accident or health insurance, explaining that generally amounts held in a qualified plan that are used to pay accident or health insurance premiums are taxable distributions under § 72 in the taxable year in which the premium is paid. They are effective on 5/12/14, and generally apply

for taxable years that begin on or after 1/1/15, but retroactive applicability is available at the taxpayer's election.

- This provision is taxpayer-favorable because insurance benefits received may generally be excluded from income only if the taxpayer himself paid the insurance premiums with non-deductible dollars.

#### **5. Final regulations on longevity annuity contracts.**

T.D. 9673, Longevity Annuity Contracts, 79 F.R. 37633 (7/2/14). Final regulations under Reg. §§ 1.401(a)(9)-5 and -6, with respect to the role that deferred annuity contracts may play under the required minimum distribution rules. In general, these contracts are limited to a total premium that does not exceed \$125,000 and is not in excess of 25 percent of the amount that is in the plan, with annuity payouts required to begin no later than age 85.

#### **6. Some inflation adjusted numbers**

**for 2015.** I.R. 2014-99 (10/23/14).

- Elective deferral in §§ 401(k), 403(b), and 457 plans, increases (from \$17,500) to \$18,000 with a catch-up provision for employees aged 50 or older of \$6,000 (increased from \$5,500).

- The limit on contributions to an IRA will be unchanged at \$5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to \$61,000-\$71,000 for single filers and heads of household, to \$98,000-\$118,000 for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and to \$183,000-\$193,000 for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to \$183,000-\$193,000 for married couples filing jointly, and to \$116,000-\$131,000 for singles and heads of household.

- The annual benefit from a defined benefit plan under § 415 is unchanged at \$210,000.

- The limit for defined contribution plans is increased (from \$52,000) to \$53,000.

- The amount of compensation that may be taken into account for various plans is increased (from \$260,000) to \$265,000, and increased (from \$385,000) to \$395,000 for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to

\$61,000 for married couples filing jointly, to \$45,750 for heads of household, and to \$30,500 for singles and married individuals filing separately.

**7. A case involving revocation of a retirement plan's qualification is different than a case involving the continuing qualification of a retirement plan. Go figure! RSW Enterprises, Inc. v. Commissioner, 143 T.C. No. 21 (11/26/14).** The petitioning corporations had established retirement plans and received a favorable determination letter from the IRS that the plans were qualified under § 401(a). The IRS later revoked the plans' qualified status on the grounds that each plan failed to (1) satisfy the coverage requirements of §§ 401(a)(3) and 410(b), and (2) satisfy the § 401(a)(26) minimum participation requirements. The corporations petitioned the Tax Court under § 7476(a) for declaratory judgments that the plans' qualified status should not have been revoked. The IRS moved for summary judgment, which the Tax Court (Judge Buch) denied because there were material factual issues in dispute. Judge Buch held that the Tax Court is not limited to considering solely the administrative record in a proceeding regarding revocation of qualified plan status where the parties disagree as to whether the administrative record contains all the relevant facts and as to whether those facts are in dispute. He rejected the IRS's argument that review was limited to the administrative record under *Stepnowski v. Commissioner*, 124 T.C. 198 (2005), *aff'd*, 456 F.3d 320 (3d Cir. 2006), which held that:

The legislative history of section 7476 makes clear that Congress did not expect the Court to conduct a trial de novo in declaratory judgment actions arising under that section, no matter whether that action arose with respect to the initial qualification or the continuing qualification of a retirement plan. . . . Therefore, discovery or introduction of extrinsic evidence in such cases is inconsistent with the legislative intent that such cases be resolved without a trial based solely on the materials contained in the administrative record.

Rather, under Tax Court Rule 217(a), “[i]n cases involving a revocation, [the court is] limited to the administrative record ‘only where the parties agree that such record contains all the relevant facts and that such facts are not in dispute.’” *Stepnowski* did not involve a revocation.

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

1. **The IRS says that it is clarifying the meaning of “substantial risk of forfeiture.”** T.D. 9659, Property Transferred in Connection with the Performance of Services Under Section 83, 79 F.R. 10663 (2/26/14). The Treasury and IRS have finalized proposed amendments to Reg. § 1.83-3 (REG-141075-09, Property Transferred in Connection With the Performance of Services Under Section 83, 77 F.R. 31783 (5/30/12)). The final regulations provide that except as specifically provided in § 83(c)(3) and Regs. §§ 1.83-3(j) and (k), a substantial risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer. When determining whether a substantial risk of forfeiture exists based on a condition related to the purpose of the transfer, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered. In addition, the final regulations clarify that except as specifically provided in § 83(c)(3) and Reg. § 1.83-3(j) and (k), transfer restrictions do not create a substantial risk of forfeiture, even if transfer restrictions carry the potential for forfeiture or disgorgement of some or all of the property, or other penalties, if the restriction is violated. Two additional examples have been added to Reg. § 1.83-3(c)(4), illustrating that a substantial risk of forfeiture is not created solely as a result of potential liability under Rule 10b-5 of the Securities Exchange Act of 1934 or a lock-up agreement. (This change incorporates the holding of Rev. Rul. 2005-48, 2005-2 C.B. 259 (which has been obsoleted by the Treasury Decision), holding that if an employee exercises a nonstatutory option more than six months after grant, and thus outside the period covered by § 16 of the Securities Exchange Act of 1934, but is subject to restrictions on his ability to sell the stock obtained through exercise of the option under Rule 10b-5 under the Securities Exchange Act of 1934 and “lock-up” contractual provisions imposed by the employer in connection with a public offering, the employee is required to recognize income under § 83 at the time of the exercise of the option because full enjoyment of the shares is not conditioned on any obligation to provide future services.)

- The preamble states:

These regulations are intended to clarify the definition of a substantial risk of forfeiture and are consistent with the interpretation that the IRS historically has applied, and therefore from the perspective of Treasury and the IRS they do not constitute a narrowing of the requirements to establish

a substantial risk of forfeiture. *See Robinson v. Commissioner*, 805 F.2d 38 (1st Cir. 1986).

- The final regulations apply to property transferred on or after January 1, 2013.

**2. Nonstatutory stock options and stock-settled stock appreciation rights with respect to stock of a nonqualified entity are not subject to taxation under § 457A.** Rev. Rul. 2014-18, 2014-26 I.R.B. 1104 (6/10/14), *amplifying* Notice 2009-8, 2009-4 I.R.B. 347. Neither a nonstatutory stock option nor a stock-settled stock appreciation right with respect to common stock of a nonqualified entity (e.g., a foreign corporation which is a nonqualified entity for purposes of § 457A(b)) is a nonqualified deferred compensation plan subject to taxation under § 457A.

#### **D. Individual Retirement Accounts**

**1. Are non-spousal inherited IRAs exempt from claims of creditors in bankruptcy? This decision created a conflict among the circuits.** *In re Clark*, 714 F.3d 559 (7th Cir. 4/23/13), *aff'd sub. nom. Clark v. Rameker*, 134 S. Ct. 2242 (6/12/14). In an opinion by Judge Easterbrook, the Seventh Circuit held that an IRA inherited from someone other than the recipient's spouse was not exempt from claims of creditors in bankruptcy. The debtors were a married couple. The wife, Heidi Heffron-Clark, was named as beneficiary of her mother's IRA and, following her mother's death, transferred the funds to a Beneficiary Individual Retirement Account, commonly known as an inherited IRA. The debtors subsequently filed a chapter 7 bankruptcy petition and claimed an exemption for the funds in the inherited IRA under 11 U.S.C. § 522(b)(3)(C), which exempts from the claims of creditors "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under" certain Code sections, including § 408. (A similar exemption with identical language is found in 11 U.S.C. § 522(d)(12).) Judge Easterbrook reasoned that the funds in an inherited IRA are not "retirement funds" within the meaning of the statute: "an inherited IRA is a time-limited tax-deferral vehicle, but not a place to hold wealth for use after the new owner's retirement." He drew an analogy to the Bankruptcy Code's homestead exemption. A person who inherits a parent's home and rents it out, he reasoned, could not claim that the home is exempt from the claims of creditors because it used to be their parent's home. The Seventh Circuit's decision conflicts with several Bankruptcy Court and District Court decisions, as well as the Fifth Circuit's decision in *In re Chilton*, 674 F.3d 486 (5th Cir. 3/3/12).

**a. The U.S. Supreme Court says the Seventh Circuit got it right and the Fifth Circuit got it wrong—funds in an inherited IRA are not exempt from claims of creditors in bankruptcy.** Clark v. Rameker, 134 S. Ct. 2242 (6/12/14). In the Supreme Court, all members of the Court joined in an opinion by Justice Sotomayor in which the Court affirmed the Seventh Circuit and concluded that funds in an inherited IRA are not “retirement funds” within the meaning of 11 U.S.C. § 522(b)(3)(C) and therefore are not exempt from claims of creditors in bankruptcy. The Court stated that three legal characteristics of inherited IRAs lead to the conclusion that “funds held in such accounts are not objectively set aside for the purpose of retirement.” These characteristics are: (1) the holder of an inherited IRA is not permitted to contribute additional funds to the account; (2) the beneficiary of an inherited IRA is required to withdraw the funds (either within five years after the year of the owner’s death or through minimum annual distributions) regardless of how many years the beneficiary is from retirement; and (3) the holder of an inherited IRA can withdraw funds from the account at any time and for any purpose without penalty. The Court also reasoned that its interpretation of the statutory language was “consistent with the purpose of the Bankruptcy Code’s exemption provisions.” Permitting the holder of an inherited IRA to exempt the funds from her bankruptcy estate would “convert the Bankruptcy Code’s purposes of preserving debtors’ ability to meet their basic needs and ensuring that they have a ‘fresh start,’ . . . into a ‘free pass.’”

• Justice Sotomayor stated, in dictum, with respect to IRAs received by a decedent’s spouse:

An inherited IRA is a traditional or Roth IRA that has been inherited after its owner’s death. See §§ 408(d)(3)(C)(ii), 408A(a). If the heir is the owner’s spouse, as is often the case, the spouse has a choice: He or she may “roll over” the IRA funds into his or her own IRA, or he or she may keep the IRA as an inherited IRA (subject to the rules discussed below). See Internal Revenue Service, Publication 590: Individual Retirement Arrangements (IRAs), p. 18 (Jan. 5, 2014). When anyone other than the owner’s spouse inherits the IRA, he or she may not roll over the funds; the only option is to hold the IRA as an inherited account.

This statement appears to be contradicted in 4 COLLIER ON BANKRUPTCY ¶ 522.09 (16th ed., 2010) (Categories of Exempt Property—Federal Exemptions; § 522(d)), which reads:

An IRA is treated differently under the Internal Revenue Code if it is inherited by the owner's surviving spouse. When a married owner of an IRA dies, the owner's surviving spouse who inherits the account may treat the account as his or her own account by designating himself or herself as the account owner or by rolling it over into his or her own IRA account. Unlike an IRA inherited by a non-spouse, if the surviving spouse takes either of these actions, he or she cannot withdraw any funds in the account until age 59½ without paying a penalty, and must begin withdrawals when he or she reaches age 70½. An IRA that is held or rolled over in this manner by a surviving spouse retains the characteristics of retirement funds within the meaning attributed to that term by the Court in *Clark v. Rameker* and should be exempt under sections 522(d)(12) and 522(b)(3)(C). (footnote omitted)

When the married owner of a retirement account dies, the safest course of action—from the standpoint of possible bankruptcy of the surviving spouse—is to roll the account over into the surviving spouse's IRA.

- COLLIER ON BANKRUPTCY also addresses the alternative possibility of state bankruptcy law exemptions:

If an inherited IRA is exempt under state law, the debtor may claim it as exempt in a bankruptcy case if the debtor's state has opted out of the federal exemption scheme or if the debtor elects to use state law exemptions in a non-opt-out state. Some state exemption statutes either define a covered retirement fund or plan to include an inherited IRA, or more generally apply the exemption to any interest in a retirement account held by a beneficiary. Debtors seeking to exempt an inherited IRA should consider whether an exemption can be claimed under state law rather than under sections 522(d)(12) and 522(b)(3)(C). (footnotes omitted)  
Id.

**2. The “one rollover per year rule” of § 408(d)(3)(B) applies to all of a taxpayer's IRAs, not to each one separately.** Bobrow v. Commissioner, T.C. Memo. 2014-21 (1/28/14). The taxpayers, a married couple, maintained more than one IRA. During 2008, the husband, a tax attorney, withdrew \$65,064 from his traditional IRA on April 14 and withdrew the same amount from his rollover IRA on June 6. He deposited \$65,064 in his traditional IRA on June 10 and deposited the same amount in his rollover

IRA on August 4. The taxpayers took the position that they were eligible to exclude both distributions from gross income under the 60-day rollover rule of § 408(d)(3)(A) because the “one rollover per year” rule of § 408(d)(3)(B) applies separately to each IRA maintained by a taxpayer. The Tax Court (Judge Nega) held that the once-per-year limitation of § 408(d)(3)(B) “is not specific to any single IRA maintained by an individual but instead applies to all IRAs maintained by a taxpayer.” In doing so, the court relied on the plain language of § 408(d)(3)(B) and its prior holdings in *Martin v. Commissioner*, T.C. Memo. 1992-331 (6/8/92), *aff’d*, 987 F.2d 770 (5th Cir. 1993) and *Martin v. Commissioner*, T.C. Memo. 1994-213 (5/12/94). Thus, according to the court, a taxpayer who maintains multiple IRAs cannot make a tax-free rollover from each IRA within the one-year period. As a result, the court concluded that the husband’s June 6 withdrawal from his rollover IRA was includible in gross income because, during the one-year period ending on that date, he had made a tax-free rollover of funds (the April 14 withdrawal) from his traditional IRA. The court also concluded that a withdrawal from the wife’s traditional IRA was taxable and subject to the 10 percent penalty tax of § 72(t) because the funds were rolled over one day outside the 60-day limitation period and the wife was under age 59½.

- The court upheld a 20 percent § 6662(a) accuracy-related penalty for substantial understatement of income tax. In doing so, the court stated: “Petitioners cite no authority supporting their position that the section 408(d)(3)(B) limitation applies separately to each IRA maintained by a taxpayer and not, as respondent argues and we agree, that the limitation applies across all IRAs maintained by a taxpayer.” The court did not discuss or cite Prop. Reg. § 1.408-4(b)(4)(ii) or IRS Publication 590, Individual Retirement Arrangements (IRAs), both of which provide that the one-rollover-per-year rule applies separately to each IRA that a taxpayer maintains.

- The court noted that its ruling does not affect trustee-to-trustee transfers of IRA funds because transferring funds directly between trustees is not a distribution within the meaning of § 408(d)(3)(A).

**a. The IRS plans to withdraw its guidance that conflicts with its victory in *Bobrow*.** Announcement 2014-15, 2014-16 I.R.B. 973 (3/20/14). The IRS “anticipates that it will follow the interpretation of § 408(d)(3)(B) in *Bobrow* and, accordingly, intends to withdraw the proposed regulation and revise Publication 590 to the extent needed to follow that interpretation.” To allow IRA trustees time to make changes in procedures and IRA disclosure documents, “the IRS will not apply the *Bobrow* interpretation of § 408(d)(3)(B) to any rollover that involves an IRA distribution occurring before January 1, 2015.” The Announcement provides that the IRS expects to issue a proposed regulation consistent with the Tax

Court's interpretation in Bobrow regardless of the ultimate resolution of that case.

**b. “Taxpayers rely on IRS guidance at their own peril.”** Bobrow v. Commissioner, No. 7022-11 (U.S. Tax Court 4/14/14). In a subsequent order dated 4/14/14 (available on the Tax Court's web site), Judge Nega dismissed the taxpayer's motion for reconsideration as moot because the parties had reached a settlement. In the order, Judge Nega discussed an amicus curiae brief filed in support of the taxpayer's motion by the American College of Tax Counsel in which the College argued that the court should conform its holding to IRS Publication 590 and that proposed regulations serve as a source of substantial authority that mitigates or negates an accuracy-related penalty. Judge Nega stated that he was aware of the position reflected in IRS Publication 590 when he issued his opinion and that, even if the taxpayers had relied on the publication in their briefs, “such an argument would not have served as substantial authority for the position taken on their tax returns.” He added: “taxpayers rely on IRS guidance at their own peril.”

**c. And the IRS follows through on its plan to withdraw the proposed regulation that supported the taxpayer's position in Bobrow.** REG-209459-78, Individual Retirement Plans and Simplified Employee Pensions; Partial Withdrawal, 79 F.R. 40031 (7/11/14). The preamble states that “[t]he IRS intends to follow the opinion in Bobrow and, accordingly, is withdrawing paragraph (b)(4)(ii) of § 1.408-4 of the proposed regulations and will revise Publication 590.” The preamble confirms that “[t]his interpretation of the rollover rules under section 408(d)(1)(B) does not affect the ability of an IRA owner to transfer funds from one IRA trustee or custodian directly to another, because such a transfer is not a rollover and, therefore, is not subject to the one-rollover-per-year limitation of section 408(d)(3)(B).” See Rev. Rul. 78-406, 1978-2 C.B. 157.” It also states that, “[c]onsistent with [Announcement 2014-15], the IRS will not apply the Bobrow interpretation of section 408(d)(3)(B) to any rollover that involves a distribution occurring before January 1, 2015.”

**d. Don't roll me over (except sometimes).** Announcement 2014-32, 2014-48 I.R.B. 907 (11/10/14). The IRS will apply the Bobrow interpretation of § 408(d)(3)(B) for distributions that occur on or after January 1, 2015. Thus an individual receiving an IRA distribution on or after January 1, 2015, cannot roll over any portion of the distribution into an IRA if the individual has received a distribution from any IRA in the preceding one-year period that was rolled over into an IRA. Under a transition rule, for

distributions in 2015 a distribution occurring in 2014 that was rolled over is disregarded for purposes of determining whether a 2015 distribution can be rolled over under § 408(d)(3)(A)(i), provided that the 2015 distribution is from a different IRA that neither made nor received the 2014 distribution. The Bobrow aggregation rule, which takes into account all distributions and rollovers among an individual's IRAs, will apply to distributions from different IRAs only if each of the distributions occurs after 2014.

- A rollover from a traditional IRA to a Roth IRA is not subject to the one-rollover-per-year limitation, and such a rollover is disregarded in applying the one-rollover-per-year limitation to other rollovers. However, a rollover between an individual's Roth IRAs would preclude a separate rollover within the one-year period between the individual's traditional IRAs, and vice versa.

- The one-rollover-per-year limitation also does not apply to a rollover to or from a qualified plan (and such a rollover is disregarded in applying the one-rollover-per-year limitation to other rollovers), nor does it apply to trustee-to-trustee transfers. *See* Rev. Rul. 78-406, 1978-2 C.B. 157.

**3. The “myRA”: President Obama directs Treasury to create a new type of Roth IRA investment vehicle with a government-guaranteed rate of return.** On 1/29/14, President Obama signed an Executive Memorandum directing Treasury to set up a new retirement account, called a “myRA,” which will be offered by employers to employees. Obama Signs Executive Order Setting Up ‘myRA’ Retirement Accounts, 2014 TAX NOTES TODAY 20-6 (1/30/14). According to a fact sheet issued by the White House (*FACT SHEET Opportunity for All: Securing a Dignified Retirement for All Americans*, 2014 TAX NOTES TODAY 20-42 (1/29/2014)), the myRA, which is to be based on the Roth IRA, will offer principal protection backed by the U.S. government, will be portable, will require initial investments of only \$25, will permit contributions through payroll deductions as low as \$5, and will permit tax-free withdrawal of contributions at any time. The myRA will be available to low- and middle-income households earning up to \$191,000. Participants will be able to save up to \$15,000, or for a maximum duration of 30 years, in their accounts before transferring their balance to a private sector Roth IRA. The Executive Memorandum directs Treasury to finalize the development of the myRA by 12/31/14.

**4. The Eighth Circuit, “appalled” at the unfairness of the government’s position and characterizing a government argument as “downright silly,” finds a valid partial rollover of IRA funds.** Haury v. Commissioner, 751 F.3d 867 (8th Cir. 5/12/14). During 2007, the taxpayer made several withdrawals from his IRA in order to make loans to two

corporations in which he held stock. The taxpayer served as a board member and senior officer of each corporation and licensed to them certain technology he had developed. The taxpayer withdrew a total of \$434,964.38 from his IRA during 2007 by making five separate withdrawals, including a withdrawal of \$120,000 on February 15. The taxpayer also deposited \$120,000 in his IRA on April 30. The Eighth Circuit, in an opinion by Judge Loken, reversed the Tax Court (Judge Foley) and concluded that the taxable IRA distributions were not \$434,964.38, but rather that amount reduced by the \$120,000 the taxpayer deposited on April 30. The Eighth Circuit reasoned that the Tax Court incorrectly concluded that the \$120,000 deposit was a payment into the IRA that occurred more than sixty days after the \$120,000 withdrawal on February 15. The taxpayer made a subsequent withdrawal of \$168,000 on April 9, and the \$120,000 deposit on April 30 qualified under § 408(d)(3)(D) as a partial rollover of the subsequently withdrawn funds. Judge Loken stated that the court was “appalled at the unfairness of” the government’s contention that the taxpayer, who had proceeded pro se in the Tax Court, had waived the partial rollover argument by not raising it below. Judge Loken also found “downright silly” the government’s argument that the taxpayer had failed to prove that he had not made another tax-free rollover within the one-year period ending on April 30 because the government had access to all of the taxpayer’s IRA transactions during that period and had failed to identify a disqualifying prior rollover.

**5. Another sad self-directed IRA story.** Dabney v. Commissioner, T.C. Memo. 2014-108 (6/5/14). The taxpayer wanted to purchase real property in his self-directed IRA at Charles Schwab, but the trustee would not execute the transaction. To complete the transaction, he directed the trustee to pay the purchase price out of the IRA and directed the title company handling the transaction to title the property in the name of “Guy M. Dabney Charles Schwab & Co. Inc. Cust. IRA Contributory.” Through a bookkeeping error, the property was titled in the taxpayer’s name. Two years later he sold the property at a profit and the sales proceeds were wired directly into his Charles Schwab IRA. He treated the deposit as a rollover contribution, and Charles Schwab accepted the deposit as such. Contemporaneously with the sale, the taxpayer discovered that the property was incorrectly titled in his own name, and he promptly sought and received a scrivener’s affidavit from the title company in which it admitted fault for the error. The Tax Court (Judge Vasquez) upheld the IRS’s determination that the 2009 distribution was a taxable (premature, because the taxpayer was not 59½) withdrawal. The taxpayer could not be treated as purchasing the property on behalf of the IRA because Charles Schwab did not permit its IRAs to hold real property. The withdrawal also was not a trustee-to-trustee transfer and was not rolled-over within 60 days. “The flaw was not in Mr. Dabney’s intent but in his execution.

Had Mr. Dabney initiated a rollover or a trustee-to-trustee transfer of funds from his Charles Schwab IRA to a different IRA—one permitted to purchase and hold real property—he would have achieved his goal without any unintended tax consequences.” The court declined to impose accuracy-related penalties.

**6. Yet another “the tax statute is unconstitutional” argument falls on deaf ears.** *Shankar v. Commissioner*, 143 T.C. No. 5 (8/26/14). Mr. Shankar and his wife, Ms. Trivedi, filed a joint return, reporting an AGI of \$243,729. Ms. Trivedi participated in an employer sponsored qualified retirement plan. They claimed an \$11,000 deduction for IRA contributions, which the IRS disallowed under § 219(g) because the taxpayers’ combined AGI was in excess of the phase-out ceiling for IRA contributions for both the participant in a qualified retirement plan and the spouse of the participant in a qualified retirement plan. The taxpayers argued that § 219(g) is unconstitutional because it discriminates against self-employed individuals who contribute to IRAs by imposing restrictions on IRA contribution deductions that do not apply to tax benefits afforded to participants in other types of retirement plans. It was unclear whether the taxpayers were arguing that § 219(g) is unconstitutional because it discriminates against Ms. Trivedi, Mr. Shankar, or both. The Tax Court (Judge Halpern) held that if the argument was that § 219(g) discriminated against Ms. Trivedi, an active participant in a qualified retirement plan, that exact argument was rejected in *Guest v. Commissioner*, 72 T.C. 768 (1979). *Guest* held that, “because the classification in section 219(b)(2) that differentiated between active participants in retirement plans and nonparticipants in retirement plans did not involve a fundamental right or a suspect category, it was constitutional if the classification had a reasonable basis,” and an examination of the legislative history revealed a reasonable basis for the classification. If the argument was that § 219(g) discriminated against Mr. Shankar, the spouse of an active participant in a qualified retirement plan, which was not directly addressed in *Guest*, the framework for the analysis was the same. The classification was reasonable because “[w]hether the individual or the spouse (or each) is an active participant, the economic family unit has the ability to save in a tax-favored manner as much as Congress thinks proper through active participation in an employer-sponsored plan (or plans) and to the extent IRA contribution deductions are allowed.”

**7. “♪♪Roll me over . . . And do it again.♪♪” Or not!** *Bohner v. Commissioner*, 143 T.C. No. 11 (9/23/14). The taxpayer, a retired federal employee who participated in the Civil Service Retirement System (CSRS), was informed by the CSRS that he could increase his CSRS

retirement annuity by paying an additional amount into the CSRS. He paid the amount on April 27, 2010. To make this contribution, he withdrew funds from his bank account and borrowed additional funds. He repaid the loan and restored the balance of his bank account by making withdrawals from his traditional IRA. He received a distribution of \$5,000 on April 15, 2010, and a distribution of \$12,832 on May 3, 2010. The taxpayer did not report any of the amounts he withdrew from his IRA as taxable income, taking the position that he engaged in a tax-free rollover under § 408(d)(3). The IRS argued that rollover contributions cannot be made to the CSRS. The Tax Court, in a reviewed opinion (8-1-6) by Judge Kerrigan, held that because the CSRS did not accept the taxpayer's remittance as a rollover, he was required to include his withdrawals in gross income. The linchpin of the majority's reasoning appeared to be that "[t]he statutory provisions governing CSRS do not include a provision allowing pretax employee contributions."

- Judge Buch (joined by Judges Holmes, Halpern, Foley, Gustafson, and Morrison) dissented with respect to the disallowance of rollover treatment for the \$5,000 distribution made on April 15, 2010. The dissent reasoned that nothing in § 408 prohibited treatment of the additional contribution to the CSRS as a rollover and that statute alone was controlling. "The statutory scheme places no weight on whether CSRS has a practice of accepting rollover contributions. Indeed, the statute places no weight on a plan's preferences regarding accepting rollovers when determining the taxability of a rollover distribution." The dissenting opinion added that the second distribution "may fail to qualify as a rollover for reasons not addressed here."

- Judge Halpern (joined by Judges Holmes and Buch) dissented from the reasoning, but would have reached the same result with respect to the \$12,832 distribution received on May 3, 2010. Judge Halpern reasoned that a distribution cannot be rolled over before it is received.

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

1. **Same-sex spouses in valid marriages now get to share in marriage penalties and marriage bonuses when filing income tax returns because "the principal purpose and the necessary effect of [DOMA] are to demean those persons who are in a lawful same-sex marriage."** *United States v. Windsor*, 133 S. Ct. 2675 (6/26/13). The Defense of Marriage Act (DOMA), Pub. L. No. 104-199, 110 Stat. 2419 (1996), defines "marriage" in any act of Congress, which (of course) includes the Code, as a legal union "between one man and one woman" as husband and

wife. DOMA also defines the word “spouse” to mean only a person of the “opposite sex” who is a husband or wife. This case involved whether the § 2056 estate tax marital deduction was allowable with respect to a bequest to a same-sex spouse whose marriage to the decedent was recognized under local law. The Supreme Court held that § 3 of DOMA—the provision that limits the meaning of the word “marriage” to “a legal union between one man and one woman as husband and wife,” and provides that “the word ‘spouse’ refers only to a person of the opposite sex who is a husband or wife”—was an unconstitutional denial of equal protection in violation of the Due Process Clause of the Fifth Amendment. As a result, the § 2056 estate tax marital deduction was allowable. It follows that, for income tax purposes, same-sex married couples whose marriages are recognized by local law are eligible to file a joint return and if they do not file a joint return must file as married filing separately.

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

- Other questions for a future time include whether same sex spouses can toggle into and out of marriages when they change residence and whether domestic partnerships in some states that are not called marriage will be treated as marriage under federal law.

**a. Shakespeare called it “The Merry Wives of Windsor.” And the IRS interprets *Windsor* broadly—a same-sex marriage celebrated under the laws of one state is a federal tax “marriage” in every state.** Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (8/29/13). In the wake of *United States v. Windsor*, 133 S. Ct. 2675 (2013), the IRS ruled that the marital status of individuals of the same-sex who are lawfully married under the laws of a state that recognizes such marriages will be recognized for all purposes. The ruling held that for Federal tax purposes (1) the terms “spouse,” “husband and wife,” “husband,” and “wife” include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term “marriage” includes such a marriage between individuals of the same sex; and (2) a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two

individuals of the same sex will be recognized even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. However the terms “spouse,” “husband and wife,” “husband,” and “wife” do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term “marriage” does not include such formal relationships.

- Taxpayers may file amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from this ruling if the statute of limitations is open. The ruling applies retroactively with respect to any employee benefit plan or arrangement or any benefit provided thereunder for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under §§ 106, 117(d), 119, 129, or 132 based on an individual’s marital status.

**b. Correcting overpayments of FICA taxes and income tax withholding resulting from the *Windsor* decision and Rev. Rul. 2013-17 just got a little easier.** Notice 2013-61, 2013-44 I.R.B. 432 (9/23/13). In the wake of *United States v. Windsor*, 133 S. Ct. 2675 (2013), the IRS issued Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (8/29/13), in which it ruled that same-sex couples who are lawfully married under the laws of a state or foreign jurisdiction will be recognized as married for federal tax purposes. Rev. Rul. 2013-17 permits taxpayers to file amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax resulting from the ruling if the statute of limitations is open. The notice provides guidance for employers and employees to make claims for refunds or adjustments of overpayments of FICA taxes and federal income tax withholding with respect to: (1) health coverage benefits or fringe benefits provided by an employer to a same-sex spouse that are excludable from income under §§ 106, 117(d), 119, 129, or 132 based on an individual’s marital status; and (2) remuneration for services performed in the employ of an individual’s spouse that are excepted from FICA tax under § 3121(b)(3)(B). To correct overpayments of FICA taxes, employers can use the regular procedures for doing so or special, simplified administrative procedures provided in the notice for correcting overpayments made in 2013 or in prior years. If an employer corrects overpayments of FICA taxes for prior years, the usual requirements apply, including the filing of Form W-2c, Corrected Wage and Tax Statement. Employers cannot correct overpayments of withheld income tax after the end of a calendar year unless the overpayment is attributable to administrative

error. Accordingly, an employer can use the special administrative procedures to correct overpayments of income tax withholding only for 2013 and only by repaying or reimbursing the employee during 2013 for the over-collected income tax.

**c. Same sex marriage fringe benefits.** Notice 2014-1 2014-2 I.R.B. 270 (12/17/13). This notice provides guidance in Q&A format regarding the application of § 125 cafeteria plans, including health and dependent care flexible spending arrangements (FSAs), and § 223, relating to health savings accounts (HSAs), to same-sex spouses following *United States v. Windsor*, 133 S. Ct. 2675 (2013), and Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

**d. Guidance on the application of *Windsor* and Rev. Rul. 2013-17 to qualified plans.** Notice 2014-19, 2014-17 I.R.B. 979 (4/4/14). This notice provides guidance in Q&A format on the application of the decision in *United States v. Windsor*, 133 S. Ct. 2675 (2013), and the holdings of Rev. Rul. 2013-17, 2013-38 I.R.B. 201, to retirement plans qualified under § 401(a). This guidance is necessary because there are many special rules in the Code that apply to married participants in qualified retirement plans, such as the requirement of § 401(a)(11) that certain qualified retirement plans must provide a qualified joint and survivor annuity upon retirement to married participants. The notice addresses whether, when, and for what periods plans must be amended to reflect the outcome of the *Windsor* decision and the guidance in Rev. Rul. 2013-17. The notice provides that “[t]he deadline to adopt a plan amendment pursuant to this notice is the later of (i) the otherwise applicable deadline under section 5.05 of Rev. Proc. 2007-44, or its successor, or (ii) December 31, 2014.”

**e. Section 401(k) and 401(m) safe harbor plans can make mid-year amendments pursuant to Notice 2014-19 to reflect *Windsor* and Rev. Rul. 2013-17.** Notice 2014-37, 2014-24 I.R.B. 1100 (5/15/14). This notice resolves uncertainty concerning whether mid-year plan amendments are permitted to § 401(k) and § 401(m) safe harbor plans by specifying that sponsors of such plans can adopt mid-year amendments pursuant to Notice 2014-19 to reflect the decision in *United States v. Windsor*, 133 S. Ct. 2675 (2013), and the holdings of Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

**2. And the IRS starts administering national health care.** T.D. 9632, Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage, 78 F.R. 53646 (8/30/13). The IRS and Treasury

have promulgated Reg. §§ 1.5000A-0 through 1.5000A-5 providing comprehensive guidance regarding the requirement to maintain minimum essential coverage under § 5000A, which was enacted by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, as amended by the TRICARE Affirmation Act and Public Law 111–173. The regulations provide guidance to individual taxpayers on their liability under § 5000A for the shared responsibility payment for not maintaining minimum essential coverage. The T.D. largely finalizes the rules in REG–148500–12, 78 F.R. 7314 (2/1/13). The regulations were effective on 8/30/13.

**a. The IRS provides relief from the individual mandate penalty for months in 2014 in which individuals have certain limited-benefit health coverage available under Medicaid or to members of the uniformed services.** Notice 2014-10, 2014-9 I.R.B. 605 (2/24/14). The final and proposed regulations regarding the requirement to maintain minimum essential coverage under § 5000A specify that certain government-sponsored, limited-benefit coverage available under Medicaid or to members of the uniformed services is not minimum essential coverage. T.D. 9632, Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage, 78 F.R. 53646 (8/30/13); REG-141036-13, Minimum Essential Coverage and Other Rules Regarding the Shared Responsibility Payment for Individuals, 79 F.R. 43021 (1/27/14) (subsequently finalized in T.D. 9705, Minimum Essential Coverage and Other Rules Regarding the Shared Responsibility Payment for Individuals, 79 F.R. 70464 (11/26/14)). The notice announces that the penalty imposed by § 5000A on individuals who do not maintain minimum essential coverage and do not qualify for an exemption does not apply for months in 2014 when the individual has one of the types of government-sponsored, limited benefit coverage identified in the final and proposed regulations.

**b. Final regulations provide guidance on issues related to the Affordable Care Act's individual mandate.** T.D. 9705, Minimum Essential Coverage and Other Rules Regarding the Shared Responsibility Payment for Individuals, 79 F.R. 70464 (11/26/14). The Treasury and IRS have finalized proposed regulations that provide guidance on issues related to the requirement of § 5000A that individuals maintain minimum essential coverage (REG-141036-13, Minimum Essential Coverage and Other Rules Regarding the Shared Responsibility Payment for Individuals, 79 F.R. 4302 (1/27/14)). Under § 5000A, individuals who do not maintain minimum essential coverage and do not qualify for an exemption are subject to a penalty beginning in 2014. The Treasury Department and the IRS

previously issued final regulations that (1) provide that coverage under the Medicaid program is minimum essential coverage except for certain Medicaid coverage that may provide limited benefits, and (2) state in the preamble that future regulations may identify other government-sponsored programs that are not minimum essential coverage. T.D. 9632, Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage, 78 F.R. 53646 (8/30/13).

- These final regulations address the government-sponsored programs mentioned in the preamble to T.D. 9632 and make clear that they do not provide minimum essential coverage. These are the following government-sponsored programs that do not provide coverage for comprehensive medical care: (1) experimental, pilot, or demonstration projects that promote the objectives of the Medicaid program and are authorized under § 1115(a) of the Social Security Act; (2) programs adopted by some states to offer benefits to the medically needy that are more limited than the benefits generally provided to Medicaid beneficiaries; (3) care available only on a space-available basis in a facility of the uniformed services; and (4) coverage provided for individuals who are not on active duty and are entitled only to episodic care for an injury, illness, or disease incurred or aggravated in the line of duty. The preamble to the final regulations notes that the Secretary of Health and Human Services may recognize certain coverage under a section 1115 demonstration project or Medicaid coverage for medically needy individuals as minimum essential coverage. The Department of Health and Human Services has issued guidance on the considerations it intends to apply in recognizing these coverages as minimum essential coverage. HHS Centers for Medicare & Medicaid Services, Minimum Essential Coverage (SHO #14-002) (Nov. 7, 2014) (available at [www.medicaid.gov/federal-policyguidance/downloads/sho-14-002.pdf](http://www.medicaid.gov/federal-policyguidance/downloads/sho-14-002.pdf)).

- The final regulations provide guidance on the exemption for individuals who have no affordable coverage by specifying how employer contributions to a § 125 cafeteria plan or a health reimbursement arrangement and reductions in an employee's premium pursuant to wellness program incentives are taken into account in determining an employee's required contribution.

- The final regulations clarify the calculation of the penalty for failing to maintain minimum essential coverage and provide guidance on an individual's ability to claim a hardship exemption without obtaining a hardship exemption certification. Unlike the proposed regulations, the final regulations do not identify specific hardship circumstances that an individual can claim without a hardship exemption certification. Instead, the final regulations provide that a taxpayer can claim a hardship exemption on a federal income tax return without obtaining an exemption certification for any month that includes a day on which the taxpayer satisfies the requirements of a hardship for which the Department of Health and Human Services, the Treasury

Department, and the IRS issue published guidance.

- The final regulations were effective on 11/26/14 and apply for months beginning after 12/31/13.

**c. Guidance on the hardship exemptions an individual can claim without obtaining a hardship exemption certification.** Notice 2014-76, 2014-50 I.R.B. 946 (11/21/14). This notice provides a comprehensive list of hardship exemptions from the individual shared responsibility payment that a taxpayer can claim on a federal tax return without obtaining a hardship exemption certification from the Health Insurance Marketplace. One of the specified exemptions is for months in 2014 prior to the effective date of an individual's coverage if the individual enrolled in a plan through an exchange during the open enrollment period for 2014. The notice applies to tax years beginning after 12/31/14.

## **B. Miscellaneous Income**

**1. Atheists unite! Freedom From Religion Foundation, Inc. v. Lew,** 983 F. Supp. 2d 1051 (W.D. Wisc. 11/21/13). The District Court for the Western District of Wisconsin (Judge Crabb) held that § 107(a)(2), which excludes from gross income a minister's "rental allowance paid to him as part of his compensation," violates the Establishment Clause of the First Amendment. The court held that the plaintiff lacked standing to challenge the constitutionality of § 107(a)(1), which excludes the rental value of a parsonage provided in kind.

**a. The Seventh Circuit disappoints the atheists. Freedom From Religion Foundation, Inc. v. Lew,** 114 A.F.T.R.2d 2014-6570 (7th Cir. 11/13/14). In an opinion by Judge Flaum, the Seventh Circuit reversed and vacated the District Court's judgment on the basis that the plaintiffs lacked standing to challenge § 107(a)(2).

A person suffers no judicially cognizable injury merely because others receive a tax benefit that is conditioned on allegedly unconstitutional criteria, even if that person is otherwise 'similarly situated' to those who do receive the benefit. Only a person that has been denied such a benefit can be deemed to have suffered a cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury.

**2. National Mortgage Settlement payments to homeowners who got screwed by their lender might or might not be taxable.** Rev. Rul. 2014-2, 2014-2 I.R.B. 255 (12/18/13). This revenue ruling deals with the tax treatment of payments received by homeowners under the National Mortgage Settlement (NMS) between the government and bank mortgage servicers regarding mortgage loan servicing and foreclosure abuses. It addresses several different situations. First, a taxpayer who receives an NMS payment as a result of foreclosure on the taxpayer's principal residence must include the payment in the amount realized on the foreclosure, but the taxpayer may exclude any resulting gain from gross income to the extent allowed under § 121. Second, if the property contained one or more additional dwelling units that were not used as the taxpayer's principal residence, the entire NMS payment is allocable to the portion of the property that the taxpayer used as a principal residence. Third, a taxpayer who receives any portion of a deceased borrower's NMS payment stands in the shoes of the borrower to determine the taxable portion, if any, of the NMS payment. Any taxable amount is income in respect of a decedent (IRD) under § 691(a).

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

**4. Airline tickets from your bank are treated just like toasters were treated in the good old days.** *Shankar v. Commissioner*, 143 T.C. No. 5 (8/26/14). The taxpayer banked at Citibank, which reported on a 2009 Form 1099-MISC, Miscellaneous Income, "Other income" of \$668,

which resulted from him redeeming 50,000 “thank you points,” issued to him by Citibank by virtue of the customer relationship, to purchase an airline ticket for travel. The taxpayer did not report the income, and the IRS asserted a deficiency. (For the bigger dollar issue in the case, which got the case to the Tax Court, see Part IV.D.) At trial, the IRS introduced evidence showing that the Form 1099-MISC properly and accurately reported the income shown thereon. The Tax Court (Judge Halpern) upheld the deficiency. “[T]he omitted income was a noncash award for opening a bank account. . . . [It was] a premium for making a deposit into, or maintaining a balance in, a bank account. In other words, something given in exchange for the use (deposit) of Mr. Shankar’s money; i.e., something in the nature of interest.” As such, it was includable in gross income.

- Compare Rev. Proc. 2000-30, 2000-2 C.B. 113, which provides that a bank depositor who receives a de minimis premium for opening a new account is not required to include the value of the premium in gross income. For this purpose, a “de minimis premium” is a non-cash inducement, provided by a financial institution to a depositor opening or adding to an account, which does not have a cost to the institution in excess of \$10 (for a deposit of less than \$5,000) or \$20 (for a deposit of \$5,000 or more).

- Employees who are awarded or redeem for personal use frequent flyer miles earned on business travel for their employers could, in theory, be required to include the value they receive in gross income, but the IRS has adopted a policy not to pursue this issue. In Announcement 2002-18, 2002-1 C.B. 621, the IRS stated:

Consistent 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. Any future guidance on the taxability of these benefits will be applied prospectively.

This relief does not apply to travel or other promotional benefits that are converted to cash, to compensation that is paid in the form of travel or other promotional benefits, or in other circumstances where these benefits are used for tax avoidance purposes.

**5. When disappointed tax shelter investors win big against their incompetent tax advisors, they also win against the IRS.** Cosentino v. Commissioner, T.C. Memo. 2014-186 (9/11/14). The taxpayers invested in a tax shelter scheme to shelter gains on the sale of real estate, and

filed tax returns claiming the losses purportedly generated by the tax shelter scheme. After they discovered that the tax shelter scheme was an abusive tax shelter, they filed amended returns and paid a deficiency, interest, and penalties. Subsequently, the taxpayers recovered \$375,000 in settlement of a suit against their tax advisors that alleged the advisors were negligent and breached their fiduciary duties to the taxpayers by advising them to use what after the fact was discovered to be an abusive tax shelter. The complaint alleged damages totaling \$640,749.80: (1) advisor fees of \$45,000; (2) costs and losses incurred in connection with executing the transaction of \$9,151; (3) federal and state income taxes paid (including lost opportunity to use legitimate tax deferral methods under § 1031) in the total amount of \$456,930; (4) interest paid to the IRS of \$18,783.59; (5) penalties payable to the IRS of \$89,925; (6) interest payable to the State of Oregon of \$12,666.21; (7) penalties payable to the State of Oregon of \$8,294.00; plus (8) certain interest and penalties yet to be determined. The settlement agreement did not allocate the \$375,000 among the various claimed losses. The taxpayers did not report the \$375,000 as includable in gross income and the IRS asserted a deficiency. The Tax Court (Judge Chiechi) held that under the principles of *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *Concord Instruments Corp. v. Commissioner*, T.C. Memo. 1994-248, and Rev. Rul. 57-47, 1957-1 C.B. 23, the recovery was a recovery of capital that was not includable in gross income except for amounts received for (1) damages claimed in the complaint for which they were compensated but for which they had claimed deductions that had been allowed and (2) certain damages that they claimed in the complaint and for which they were compensated but which they in fact did not incur or incurred in amounts that were less than the amounts of those damages that they alleged in the complaint. The court went on to allocate the \$375,000 ratably among the various types of damages alleged in the complaint. Accordingly, the following amounts were includable: (1) amounts allocable to costs and losses incurred in connection with executing the transaction, which had been allowed as a deduction; (2) amounts allocable to Oregon income taxes, for which a deduction had been allowed; (3) amounts allocable to federal tax penalties claimed in the complaint to have been paid that were conceded to have exceeded the penalties actually ultimately paid; and (4) amounts allocable to Oregon tax penalties claimed in the complaint to have been paid that ultimately had been waived. The actual amounts were subject to a rule 155 computation.

**6. The Tax Court reasons that there can't be COD income without a prior tax benefit.** *Mylander v. Commissioner*, T.C. Memo. 2014-191 (9/17/14). The Tax Court (Judge Vasquez) held that the taxpayer did not recognize COD income when he was released from a guarantee on which

the principal obligor had defaulted. The facts were convoluted, but the reasoning is clear and important.

Petitioners were initially secondary obligors on the Murray debt, under the terms of the guaranty. They did not receive any valuable consideration in exchange for the guaranty. Upon the Ledbetters' default, and the subsequent State court judgment and covenant not to execute, petitioners became primarily liable on the Murray debt. However, *at no point did they receive an untaxed accretion of assets with respect to the guaranty*. Accordingly, we find that, when the remaining debt was forgiven by Mr. Murray in 2010, petitioners did not have an accession to wealth and did not realize any COD income.

(Emphasis added).

With respect to minor issues, the court applied the *Cohan* rule (*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)) to allow some but not all of the taxpayer's claimed professional continuing education expenses, but did not allow a deduction for rental property expenses beyond the documented expenses.

**7. Hallelujah! The government finally recognizes that nonpayment of a debt still owed is not necessarily COD income.** REG-136676-13, Removal of the 36-Month Non-Payment Testing Period Rule, 79 F.R. 61791 (10/15/14). The IRS and Treasury have published proposed amendments to Reg. § 1.6060P-1 that would eliminate the rule that a deemed discharge of indebtedness for which a Form 1099-C, "Cancellation of Debt," must be filed occurs at the expiration of a 36-month non-payment testing period. According to the Preamble:

[I]nformation reporting under section 6050P should generally coincide with the actual discharge of a debt. Because reporting under the 36-month rule may not reflect a discharge of indebtedness, a debtor may conclude that the debtor has taxable income even though the creditor has not discharged the debt and continues to pursue collection.

**8. This may be one of the only sensible extenders.** TIPPA retroactively extended through 12/31/14 the § 108(a)(1)(E) exclusion

for up to \$2 million (\$1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness.

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

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

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

**1. Who'd a thunk that when hearing a small case the Tax Court is a court of equity?** Miller v. Commissioner, T.C. Summ. Op. 2014-74 (7/28/14). The taxpayer claimed a home office deduction with respect to space set aside in a studio apartment. The apartment was “divided” into three equal sections: (1) an entryway, a bathroom, and a kitchen area; (2) office space, including a desk, two shelving units, a bookcase, and a sofa; and (3) a bedroom area including a platform bed and dressers. Only the bathroom was a separate room. The taxpayer had to pass through the office space to get to the bedroom area. The taxpayer had no office provided by her employer and she frequently met with clients in the office space, and performed work for her employer using a computer on the desk. Although she used the office space primarily for business purposes, she occasionally used the space for personal purposes. Notwithstanding that § 280A(c)(1) specifically limits an allowable home office deduction only with respect to space used “exclusively” for business, the court (Special Trial Judge Guy) allowed the deduction: “Although petitioner admitted that she used portions of the office space for nonbusiness purposes, we find that her personal use of the space was de minimis and wholly attributable to the practicalities of living in a studio apartment of such modest dimensions.”

**2. Did they park in the Wal-Mart parking lot?** Jackson v. Commissioner, T.C. Memo. 2014-160 (8/7/14). The taxpayers owned an RV in which they attended RV rallies and from which they sold RV insurance policies. The principal issue in the case was whether they could deduct depreciation and interest with respect to the RV. The Tax Court (Judge Wherry) found that the RV was used two-thirds for business purposes and one-third for personal purposes, so that unless otherwise barred by § 280A, two-thirds of the interest and depreciation would be deductible. Although § 280A(c) allows apportionment of expenses for a dwelling unit “exclusively used” on a regular basis “as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business,” allocation was not allowed on the facts of this case because the taxpayers “did not use any portion of their RV exclusively for business.”

Section 280A casts a wide net in this regard and sometimes catches taxpayers, like petitioners, who in addition to their personal use had genuine business purposes. Thus, while petitioners' RV may be "appropriate and helpful" in their business, they have failed to meet the stringent requirements of section 280A.

To top it off, § 6662 accuracy related penalties were sustained.

**3. Too much fun and not enough work at the vacation condo is taxing.** *Van Malssen v. Commissioner*, T.C. Memo. 2014-236 (11/20/14). This case involved the computation of the allocation of expenses under § 280A(e) between personal use days and rental days with respect to a condominium that the taxpayer used personally for more than 14 days a year and for the years in question rented for various periods. Several of the taxpayer's trips to the condominium each year included both vacation days—personal use days—and maintenance and repair days—days that are not personal use days. The primary legal issue (as opposed to factual issue) with respect to the mixed purpose trips was how to count the travel days on which the taxpayer arrived and departed. After noting that "[p]roposed regulations are not binding on this Court and are given no greater weight than a litigation position, [but that] they can be useful guidelines where, as here, they closely follow the legislative history of the statutory provision in question," the court (Judge Kerrigan) applied the principles of Prop. Reg. § 1.280A-1(e)(6) and (7), Ex. (3). Prop. Reg. § 1.280A-1(e)(6) provides that "a dwelling unit shall not be deemed to have been used by the taxpayer for personal purposes on any day on which the principal purpose of the use of the unit is to perform repair or maintenance work" and uses a "facts and circumstances" test to determine the principal purpose of the taxpayer. Prop. Reg. § 1.280A-1(e)(7), Ex. (3) provides the following example relevant to the case:

A owns a lakeside cottage which A rents during the summer. A and B, A's spouse, arrive late Thursday evening after a long drive to prepare the cottage for the rental season. A and B prepare dinner but do no work on the unit that evening. A spends a normal work day working on the unit Friday and Saturday; B helps for a few hours each day but spends most of the time relaxing. By Saturday evening, the necessary maintenance work is complete. Neither A nor B works on the unit on Sunday; they depart shortly before noon. The principal purpose of the use of the unit from Thursday evening through Sunday morning is to perform maintenance work on the unit.

Consequently, the use during this period will not be considered personal use by A.

Relying on these provisions in the proposed regulations, the court found that travel days to and from the condominium were personal use days for any visit in which the majority of the taxpayer's days were vacation days, and travel days to and from the condominium were not personal use days for any visit in which the majority of the taxpayer's days were maintenance and repair days. Trips on which the taxpayer devoted an equal number of days to vacation and to maintenance and repair were found to be personal use days.

#### D. Deductions and Credits for Personal Expenses

**1. Statutory plain language trumps the Tax Court's "as if" analysis where the plain language did not produce an absurd result.** *Packard v. Commissioner*, 746 F.3d 1219 (11th Cir. 3/27/14), *rev'g* 139 T.C. 390 (11/5/12). Before the taxpayers were married and began living in the same residence on 12/1/09, the wife owned a principal residence where she resided for more than five consecutive years during the eight years before that date; husband, on the other hand, had no present ownership interest in a principal residence during the three-year period ending on that date. The Tax Court (Judge Wells) held that where wife would have qualified for the first-time homebuyer credit under § 36(c)(6) ("long-time residents of same principal residence") and the husband would have qualified for that credit under § 36(c)(1) ("first-time homebuyer"), the married couple is entitled to the credit.

- The Eleventh Circuit reversed in a per curiam opinion, because it found that the plain language of the statute required that *both* spouses qualify under either § 36(c)(1) or § 36(c)(6), and the "Tax Court's observation that the Packards would have qualified for the tax credit individually had they not been married ha[d] no bearing on the application of section 36(c) to the facts of this case."

**2. The IRS finally gets it *Knight*.**<sup>3</sup> T.D. 9664, Section 67 Limitations on Estates or Trusts, 79 F.R. 26616 (5/9/14). The Treasury and

---

3. *Knight v. Commissioner*, 552 U.S. 181 (2008), held that § 67 can apply to limit the deduction by a trust of investment advisor's fees. The clause of § 67(e)(1), excepting from the floor costs that would not have been incurred if the property were not held by a trust or estate, "excepts from the two-percent floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." At the time the *Knight* case was decided, Prop. Reg. § 1.67-4 would have resolved the conflict in the case law that preceded the *Knight* decision by providing

IRS have finalized proposed regulations under § 67 (REG-128224-06, Section 67 Limitations on Estates or Trusts, 76 F.R. 55322 (9/7/11)). Reg. § 1.67-4 provides comprehensive rules dealing with the application of the § 67(e) 2-percent floor to administration expenses incurred by estates and non-grantor trusts. In applying the 2-percent floor, the determinative factor is whether the expense “commonly or customarily would be incurred by a hypothetical individual owning the same property,” focusing on “the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service.” Fees for investment advice are covered by the 2-percent floor, but incremental costs of investment advice incurred because the advice is rendered to a trust or estate are not subject to the floor. Bundled fees, i.e., a single stated fee covering all services, can be allocated by “[a]ny reasonable method.”

### 3. The premium tax credit and federally facilitated exchanges:

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

(2) Premium assistance amount. — The premium assistance amount determined under this subsection with respect to any coverage month is the amount equal to the lesser of—

---

that only expenses incurred by estates or non-grantor trusts that are unique to an estate or trust are not subject to the § 67 two-percent floor. *Knight* expressly rejected the government’s argument that § 67(e)(1) properly could be read to limit deductible trust administration expenses only to those “unique” to a trust.

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

(A) the monthly premiums for such month for 1 or more qualified health plans offered in the individual market within a State which cover the taxpayer, the taxpayer's spouse, or any dependent (as defined in section 152) of the taxpayer *and which were enrolled in through an Exchange established by the State* under 13111 of the Patient Protection and Affordable Care Act . . .

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

- Judge Edwards vigorously dissented, characterizing the plaintiff's action as a "not-so-veiled attempt to gut the Patient Protection and Affordable Care Act" and concluding that "[t]he majority opinion ignores the obvious ambiguity in the statute and claims to rest on plain meaning where there is none to be found." His opinion emphasized that "[t]he plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole," quoting *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341 (1997). Applying this standard, considering the ACA as a whole, he applied a *Chevron*<sup>5</sup> analysis that found the language of § 36B(b)(2) to be ambiguous and the government's interpretation of the regulation to be permissible and reasonable.

- On 9/4/14, the D.C. Circuit granted the government's petition for rehearing en banc and vacated the judgment entered on 7/22/14. See [http://www.cadc.uscourts.gov/internet/opinions.nsf/6510F5166505E32985257D49004A7CCA/\\$file/14-5018-1510560.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/6510F5166505E32985257D49004A7CCA/$file/14-5018-1510560.pdf).

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

---

5. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

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

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

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

**c. The original Moops found friends in high places to peer all over the Moors.** The Supreme Court granted a petition for a writ of certiorari to the Fourth Circuit in *King v. Burwell*, 759 F.3d 358 (4th Cir. 7/22/14), and will consider the issue later this Term. 135 S. Ct. 475 (11/7/14).

**4. The IRS is undeterred by the Halbig decision.** Revenue Procedure 2014-37, 2014-33 I.R.B. 363 (7/25/14). This revenue procedure provides indexing adjustments for certain provisions under §§ 36B and 5000A. It updates the Applicable Percentage Table in § 36B(b)(3)(A)(i), which is used to calculate an individual’s premium tax credit for taxable years beginning after calendar year 2014. This revenue procedure also updates the required contribution percentage in § 36B(c)(2)(C)(i)(II), which is used to determine whether an individual is eligible for affordable employer-sponsored

minimum essential coverage under § 36B for plan years beginning after calendar year 2014. Additionally, this revenue procedure cross-references the required contribution percentage under § 5000A(e)(1)(A) for plan years beginning after calendar year 2014, as determined under guidance issued by HHS. This percentage is used to determine whether an individual is eligible for an exemption from the individual shared responsibility payment because of a lack of affordable minimum essential coverage.

**a. A bit of credit, a bit of deduction. Will TurboTax know the answer?** Rev. Proc. 2014-41, 2014-33 I.R.B. 364 (7/25/14). Some taxpayers enrolled in a qualified health plan and eligible for the premium tax credit may also be allowed a deduction under § 162(l). Reg. § 1.162(l)-1T provides rules for taxpayers who claim a § 162(l) deduction and also may be eligible for a § 36B credit for the same qualified health plan or plans. Under Reg. § 1.162(l)-1T(a)(1), a taxpayer is allowed a § 162(l) deduction for specified premiums not to exceed an amount equal to the lesser of (1) the specified premiums less the premium tax credit attributable to the specified premiums, and (2) the sum of the specified premiums not paid through advance credit payments and the additional tax imposed under § 36B(f)(2)(A) and Reg. § 1.36B-4(a)(1) with respect to the specified premiums after the application of the limitation on additional tax in § 36B(f)(2)(B) and Reg. § 1.36B-4(a)(3). This revenue procedure provides guidance for taxpayers to use in computing the § 162(l) deduction for health insurance costs for self-employed individuals and the premium tax credit allowed under § 36B. The method in the revenue procedure is optional.

**5. Every child deserves individual attention.** Lahmeyer v. United States, 114 A.F.T.R.2d 2014-5487 (S.D. Fla. 7/25/14). The taxpayer claimed an adoption credit (provided in § 23 for the year in issue, now in § 32) for adopting a child with “special needs.” The adoption credit for a child with “special needs” is more generous than the general adoption credit. The IRS disallowed the special needs credit. The statute provides that:

- The term “child with special needs” means any child if—
- (A) a State has determined that the child cannot or should not be returned to the home of his parents,
  - (B) such State has *determined* that there exists with respect to the child a specific factor or condition (such as his ethnic background, age, or membership in a minority or sibling group, or the presence of

factors such as medical conditions or physical, mental, or emotional handicaps) because of which it is reasonable to conclude that such child cannot be placed with adoptive parents without providing adoption assistance, and  
(C) such child is a citizen or resident of the United States (as defined in section 217(h)(3)).

(Emphasis added.) The question was what the word “determined” means. Florida law provides a “special needs child” includes a “child who . . . is not likely to be adopted because he or she is . . . [o]f black or racially mixed parentage.” Fla. Stat. § 409.166(2)(a). The child the taxpayers adopted had racially mixed parentage, and the taxpayers argued that a state determination had been made by virtue of the Florida statute. The government argued that notwithstanding the Florida statute, the fact that a child was of racially mixed parentage, standing alone, was insufficient because the plain language of the governing Code provision “requires not just a state determination that a particular trait exists, but that due to that trait the child could not have been placed with adoptive parents without a financial incentive to do so, i.e., ‘adoption assistance.’” The District Court (Judge Altonaga) held for the government, reasoning that “the only logical understanding of ‘determined’ implies an individualized decision about a specific child, because the statute provides no other criteria by which it could be said a child cannot or should not be returned to his or her parents’ home,” and no such specific determination with respect to the child had been made by the State of Florida.

**6. Failure to file personal income tax returns is not a business activity.** Hall v. Commissioner, T.C. Memo. 2014-171 (8/21/14). Mr. Hall operated an ophthalmology practice through an S corporation; Mrs. Hall had a legal practice as a sole proprietor; they also owned rental real estate. Mr. and Mrs. Hall were convicted for willful failure to file tax returns. They deducted the legal fees for their representation in the criminal case on Mrs. Hall’s 2006 schedule C; they also deducted on her 2006 schedule C the fees paid to a forensic accountant to determine their correct tax liabilities for the years they failed to file a return. The IRS disallowed the deduction on schedule C, allowing it only as a miscellaneous itemized deduction on Schedule A. The Tax Court (Judge Ruwe) sustained the IRS’s position that the fees were deductible only as itemized deductions. The payment arose from the Halls’ failure to file tax returns. They did not arise in connection with business activities.

**7. Generosity to one's brother doesn't reap a tax deduction.** Puentes v. Commissioner, T.C. Memo. 2014-224 (10/27/14). The taxpayer lived in a house owned by her brother and made the mortgage payments due while her brother was unemployed and she was living in the house. She claimed deductions for the real estate taxes and mortgage interest. The IRS disallowed the deductions and the Tax Court (Judge Lauber) upheld the disallowance. The taxpayer was neither the legal nor the equitable owner of the house and thus was not entitled to deduct the interest as "qualified residence interest." The mere fact that she paid the mortgage, home insurance, and property taxes during the year in question alone was not sufficient to make her an equitable owner of the property. (Note that the fact that she was not legally obligated to pay the mortgage was not determinative because in California, where the case arose, mortgages on a primary residence—her brother's home with respect to which he was the mortgagor—are nonrecourse. Reg. § 1.163-1(b) provides that a taxpayer may deduct "[i]nterest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage.")

**8. Standard deduction for 2015.** Rev. Proc. 2014-61, 2014-47 I.R.B. 860 (10/30/14). The standard deduction for 2015 will be \$12,600 for joint returns and surviving spouses, \$6,300 for unmarried individuals, \$6,300 for married individuals filing separately, and \$9,250 for heads of households.

**9. Home mortgage interest is deductible only if you actually pay it.** Copeland v. Commissioner, T.C. Memo. 2014-226 (10/30/14). In connection with a modification of a mortgage loan on the taxpayers' principal residence, for the years in question they paid approximately \$9,000 of home mortgage interest and approximately \$30,000 of past-due home mortgage interest was deferred and capitalized into the principal amount. Although the statutory language of § 163(h)(3) allows a deduction for qualified residence interest that is "paid or accrued" during the taxable year, the Tax Court (Judge Lauber) upheld the denial of a deduction for the accrued but unpaid interest, because the taxpayer was an individual on the cash method—which is the method applicable to all individuals with respect to personal expenses. Under well-established precedents, a cash method taxpayer may deduct in any taxable year only interest actually paid

during that taxable year. The accrued but unpaid qualified residence interest is not deductible until actually paid.

• *Accord Smoker v. Commissioner*, T.C. Memo. 2013-56 (2/21/13).

**10. This one's really only for taxpayers in Texas and Florida and a few other states that don't have a state income tax.** TIPA retroactively extended through 12/31/14 the § 164(b)(5)(I) election to claim an itemized deduction for state and local general sales and use taxes instead of state and local income taxes.

**11. Of course there's no chance the mortgage insurance companies will increase their premiums to capture the benefit of this deduction to the involuntary purchaser.** TIPA retroactively extended through 12/31/14 the § 163(h)(3)(E) deduction (subject to the pre-existing limitations) for mortgage insurance premiums in connection with acquisition indebtedness with respect to the taxpayer's qualified residence.

**12. Why not just increase, rather than decrease, Pell grants?** TIPA retroactively extended through 12/31/14 the § 222 above-the-line deduction for certain eligible individuals of a limited amount of qualified higher education tuition and related expenses of the taxpayer, his spouse, or dependents.

## **E. Divorce Tax Issues**

**1. If an ex-spouse disobeys a court order to sign Form 8332, the noncustodial spouse still loses. What's a guy gotta do?** *Armstrong v. Commissioner*, 139 T.C. 468 (12/19/12). The taxpayer and his wife divorced, and his ex-wife had custody of their son. A state court order provided that the taxpayer would be entitled to the dependency exemption and explicitly required his ex-wife to execute in his favor a Form 8332, "Release of Claim to Exemption for Child of Divorced or Separated Parents" provided that the taxpayer met child support obligations. The taxpayer met his child support obligations, but his ex-wife failed to provide the executed Form 8332. The IRS disallowed the taxpayer's claimed dependency exemption, even though he appended to his tax return the court order and provided the IRS evidence that he had met his support obligations. In a reviewed opinion (12-3) by Judge Gustafson, the Tax Court upheld the denial of the exemption. The state court order, even though countersigned by the taxpayer's ex-wife, was not a substitute for a Form 8332 because it failed to unconditionally declare that the ex-wife "will not claim such child as a dependent" for the year at issue.

That defect is not cured by the noncustodial parent's proof that he has fulfilled support conditions beyond those in the statute. Likewise, the child credit was disallowed.

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

**a. And the Eighth Circuit believes that the majority got it right.** *Armstrong v. Commissioner*, 745 F.3d. 890 (8th Cir. 3/13/14). In an opinion by Judge Loken, the Eighth Circuit affirmed the Tax Court's decision without even mentioning the dissenting opinion in the Tax Court.

The documents submitted by the taxpayers merely told the IRS that the custodial parents might not claim the exemptions ... in any particular tax year, not that they will not claim the exemptions. . . . We sympathize with noncustodial parents who are entitled to receive documents necessary to support their claims for federal dependency exemptions and child tax credits and their former spouses violate contractual or court-ordered obligations to provide those documents. But Congress in the 1984 amendment to § 152(e)(2) precluded attempts to remedy such wrongs in federal income tax proceedings.

- The opinion did note, however, that "if a violation of a state court order wrongly deprives the intended beneficiary of a federal tax advantage, the state court unquestionably retains authority to remedy that violation."

**2. Even before Form 8332 was required, state court orders conditioning the surrender of dependency exemptions on meeting child support obligations didn't work.** *Swint v. Commissioner*, 142 T.C. 131 (2/24/14). The Tax Court (Judge Ruwe) held that an agreed-entry state court order awarding a noncustodial parent the dependency exemption on the condition that he was current with his child support obligations was insufficient to permit him to claim the dependency exemption (and child credit) in a year before Form 8332 was required. Although a court order or

decree or a separation agreement entered prior to July 2, 2008, can be a written declaration if it satisfies certain requirements, the order in this case failed to meet those requirements. The plain language of § 152(e)(2)(A) provides that the noncustodial parent can claim the dependency exemption only if “the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year.” The taxpayer’s claim failed on two grounds: First, the custodial parent did not sign “a written declaration” because the agreed entry was not signed by her. Second, the language “will not claim” in § 152(e)(2)(A) is unconditional. “As a result, in order for a written declaration to comply with section 152(e)(2)(A) the declaration by the custodial parent that he or she ‘will not claim such child as a dependent’ must also be unconditional.” A conditional declaration cannot comply with § 152(e)(2)(A).

#### **F. Education**

There were no significant developments regarding this topic during 2014.

#### **G. Alternative Minimum Tax**

There were no significant developments regarding this topic during 2014.

### **VI. CORPORATIONS**

#### **A. Entity and Formation**

There were no significant developments regarding this topic during 2014.

#### **B. Distributions and Redemptions**

**1. If the IRS continues to choose cases with bad facts to litigate the issue of whether it’s corporate or personal goodwill, the IRS’s batting average on this issue will start to look like the taxpayers’ batting average in tax shelter cases.** *Bross Trucking, Inc. v. Commissioner*, T.C. Memo. 2014-107 (6/5/14). For many years, Mr. Bross had owned and operated Bross Trucking, Inc., using leased vehicles. Bross Trucking’s principal customers were three businesses owned by other Bross family members. Bross Trucking did not have any formal written service agreements

with its customers, relying instead on Mr. Bross's close personal relationships with the owners of the customer businesses. Due to violations of state regulatory law, Bross Trucking was in danger of losing its hauling authority. As a result, Bross's sons—who were owners of Bross Trucking's customers—formed a new trucking company, LWK Trucking, 98.2 percent of which was owned by Bross's sons' self-directed IRAs and the remainder of which was owned by an unrelated third party. Mr. Bross was not involved in managing LWK Trucking. LWK Trucking hired several Bross Trucking employees and leased trucks that formerly had been leased to Bross Trucking. Until the vehicles were repainted (or magnetic signs installed) they bore the Bross Trucking logo. The IRS asserted that Bross Trucking had distributed "its operations," including "(1) goodwill; (2) established revenue stream; (3) developed customer base; (4) transparency of the continuing operations between the entities; (5) established workforce including independent contractors; and (6) continuing supplier relationships," all of which the court collectively described as "goodwill" to Mr. Bross, triggering gain to the corporation (which did not liquidate until several years later) under § 311(b), and that Mr. Bross in turn had made a taxable gift of that goodwill to his sons. The Tax Court (Judge Paris), based on analogizing the facts in the instant case to the differences in the facts and results in *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), and *Solomon v. Commissioner*, T.C. Memo. 2008-102, concluded that except for workforce in place, Bross Trucking had no goodwill at the time of the "alleged transfer." Although it "might have had elements of corporate goodwill at some point . . . through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name." Judge Paris went on to find that: "The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry."

A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944); *Norwalk v. Commissioner*, T.C. Memo. 1998-279. Unlike the taxpayer's products in *Solomon v. Commissioner*, T.C. Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill.

Furthermore, "Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement." No other Bross

Trucking intangible assets were transferred because Bross Trucking's prior customers became LWK's customers and no longer wanted to deal with Bross Trucking due to its regulatory problems, and "LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company."

a. **♪The last time I saw [an opinion by Judge Paris]♪, it also upheld the validity of *Martin Ice Cream*. Estate of Adell v. Commissioner, T.C. Memo. 2014-155 (8/4/14). Decedent incorporated STN.Com in 1999 as a C corporation and was STN.Com's sole shareholder until he transferred the stock to a trust; however, the value of the stock was includible in his gross estate. His son, Kevin, served as STN.Com's president, but he never had an employment agreement or a noncompete agreement with STN.Com. Kevin had approached several prominent religious leaders to utilize the services of The Word, a nonprofit entity, to arrange all programming content; he also arranged for DirecTV to extract the programs from the satellite and broadcast them nationally. STN.Com's sole business purpose was to provide "uplinking" services in order to broadcast an urban religious program channel that Kevin named "The Word Network." The Word paid STN.Com at least ninety-five percent of its net programming revenue for its management, technical, and legal services in connection with uplinking services. In finding that the value of STN.Com did not include Kevin's personal goodwill, Judge Paris stated:**

Goodwill is often defined as the expectation of continued patronage by existing customers. *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 572-573, 113 S. Ct. 1670, 123 L. Ed. 2d 288 (1993). A key employee may personally create and own goodwill independent of the corporate employer by developing client relationships. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 207-208 (1998). The corporation may benefit from using the personally developed goodwill while the key employee works for the entity, but the corporation does not own the goodwill and therefore it is not considered a corporate asset. *Id.* at 208. The employee may, however, transfer any personal goodwill to the employer through a covenant not to compete or other agreement that transfers the relationships to the employer. See *id.* at 207; *H&M, Inc. v. Commissioner*, T.C. Memo. 2012-290. Absent such an agreement, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation.

Kevin's goodwill was personally owned independent of STN.Com. STN.Com's success was heavily dependent on The Word because of their symbiotic relationship. To launch The Word, it was Kevin who contacted religious leaders in the Detroit area and Rev. Jackson in Chicago. Along with his notable contacts and his father, he went to Los Angeles to meet with DirecTV representatives about broadcasting The Word. His meeting was successful and it eventually led to the national broadcasting of The Word on cable television. Kevin was the face of the operation because he was the individual soliciting content and pursuing broadcast opportunities.

Kevin's personal goodwill was further displayed when ministers chose to contribute to The Word after learning that The Word was a nonprofit organization. When contributing ministers asked about ownership opportunities, Kevin responded that The Word was a nonprofit organization and could not be sold. It appeared to the contributing ministers that there was not a corporation employing Kevin. The ministers conducted business with Kevin because they trusted him personally, not because he was a representative or employee of STN.Com. In other words, STN.Com could not own Kevin's goodwill because the customers did not readily realize that Kevin actually worked for STN.Com. Thus, he cultivated personal goodwill with these professionals and he independently owned the asset of personal goodwill, not STN.Com.

Although Mr. Adell was a board member and officer of both STN.Com and The Word, Kevin operated both companies. Kevin had the education and background to perform uplinking broadcast services. After graduating with a communications degree, he built Mr. Adell's first television station, WADL, and on account of his experience with WADL became interested in the uplinking business. Using STN.Com's predecessor, STN Satellite, Kevin learned about the uplinking business by providing uplink services to various customers, including Hughes Electronics Corp., a major customer brought on by Kevin. Kevin, who continued to explore business opportunities that would capitalize on his background, decided to combine his success with religious programming on WADL with his uplinking services from

STN Satellite by creating The Word and its uplink service provider, STN.Com.

Further, Kevin did not transfer his goodwill to STN.Com through a covenant not to compete or other agreement. Kevin was free to leave STN.Com and use his relationships to directly compete against his previous employer. If Kevin quit, STN.Com could not exclusively use the relationships that Kevin cultivated; thus, the value of those relationships should not be attributed to STN.Com.

### C. Liquidations

There were no significant developments regarding this topic during 2014.

### D. S Corporations

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

**a. And the taxpayers' invocation of a prayer to the god *Gitlitz* falls on deaf ears in the Third Circuit.** Ball v. Commissioner, 742 F.3d 552 (3d Cir. 2/12/14). The Third Circuit (in an opinion by Judge Van Antwerpen) affirmed the Tax Court's decision. The court reasoned that gains that are not recognized by virtue of a specific Code provision are not items of gross income, citing Reg. § 1.61-6(b)(1), and § 332 specifically provides nonrecognition on the liquidation of a controlled subsidiary. Thus, making the QSub election did not give rise to an item of gross income. The court found *Gitlitz v. Commissioner*, 531 U.S. 206 (2001),

to be inapposite, because *Gitlitz* addressed payments that explicitly were included in gross income under § 61(a)(12) but excluded under § 108, whereas in the instant case § 332 worked to exclude the gain from being included in gross income under § 61(a)(3).

**2. The Treasury Department finalizes major surgery on the rules for determining an S corporation shareholder's basis limitation for passed-through losses under § 1366(d).** T.D. 9682, Basis of Indebtedness of S Corporations to Their Shareholders, 79 F.R. 42675 (7/23/14). The Treasury Department has finalized amendments to Reg. § 1.1366-2 proposed in REG-134042-07, Basis of Indebtedness of S Corporations to Their Shareholders, 77 F.R. 34884 (6/12/12), that deal with determination of an S corporation shareholder's basis in any debt of the S corporation, which principally affects the limitation on the pass-through of losses under § 1366(d). The amended regulations expressly provide that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg. § 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Reg. § 1.1366-2(a)(2)(i). Furthermore, Reg. § 1.1366-2(a)(2)(ii) expressly provides that:

A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase its basis of indebtedness to the extent of that payment.

Reg. § 1.1366-2(a)(2)(iii), Ex. (4) illustrates that the basis increase from satisfaction of a guarantee occurs *pro tanto* as serial payments on the guarantee are made.

- The preamble to the proposed regulations states that "[u]nder these proposed regulations, an incorporated pocketbook transaction [*see, e.g., Yates v. Commissioner*, T.C. Memo. 2001-280; *Culnen v. Commissioner*, T.C. Memo. 2000-139] increases basis of indebtedness only

where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation.”

- Reg. § 1.1366-2(a)(2)(iii), Ex. (2), blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation “constitutes bona fide indebtedness” from the borrower S corporation to the shareholder. Example (3) in the regulation blesses a basis increase resulting from a distribution to a shareholder by one S corporation (S1) of a note evidencing the indebtedness of a second S corporation (S2) if after the distribution S2 is indebted to the shareholder and “the note constitutes bona fide indebtedness” from S2 to the shareholder where under local law the distribution relieved S2 of its obligation to S1 and S2 was liable only to the shareholder; however, whether S2 is indebted to the shareholder rather than S1 is determined under general federal tax principles and depends upon all of the facts and circumstances. Reg. § 1.1366-2(a)(2)(iii), Ex. (1), provides that a bona fide indebtedness from an S corporation to a disregarded entity (LLC) owned by the shareholder results in an increase in basis of indebtedness for the shareholder.

- The regulations do not attempt to clarify the meaning of “bona fide indebtedness,” or provide any examples of relevant facts and circumstances, but rely on “general Federal tax principles.” This leaves somewhat ambiguous what might replace the “actual economic outlay” by the shareholder test for creating basis of indebtedness, applied in cases such as *Maloof v. Commissioner*, 456 F.3d 645 (6th Cir. 2006); *Spencer v. Commissioner*, 110 T.C. 62, 78-79 (1998), *aff’d without published opinion*, 194 F.3d 1324 (11th Cir. 1999); *Hitchins v. Commissioner*, 103 T.C. 711 (1994); and *Perry v. Commissioner*, 54 T.C. 1293 (1970). The preamble to the proposed regulations refers to *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998); *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); and *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973), as relevant authorities. In the preamble to the final regulations, the Treasury department expressly declined to accept a commentator’s suggestion that the final “regulations provid[e] that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness,” but “[w]ith respect to guarantees, however, the final regulations retain the economic outlay standard.”

- The amended regulations do not address how to determine the basis of the shareholder’s stock in the S corporation. Revenue Ruling 81-187, 1981-2 C.B. 167, provides that a shareholder of an S corporation does not increase basis in stock for purposes of § 1366(d)(1)(A) by contributing the shareholder’s own unsecured demand promissory note to the corporation. In the preamble to the proposed regulations, the Treasury

Department and the IRS requested comments concerning the propriety of basis calculations in the S corporation and partnership context, similar to the one currently in Reg. § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (1) when there is a taxable disposition of such note by the partnership, or (2) when the partner makes principal payments on such note. The preamble to the final regulations states that "[t]he Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance."

- Amended Reg. § 1.1366-2(a)(2) applies to indebtedness between an S corporation and its shareholder resulting from any transaction occurring after 7/22/14. In addition, S corporations and their shareholders may rely on Reg. § 1.1366-2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before 7/23/14.

**3. The lifetime of built-in gain gets shorter every year.** The Small Business Jobs Act of 2010 shortened the holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation's tax year beginning in 2011. Before the change, the holding period was ten years for sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010.

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

**b. And yet again.** TIPA retroactively extended the § 1374 five-year holding period reduction to recognized built-in gain in 2014.

## **E. Mergers, Acquisitions, and Reorganizations**

**1. The Ninth Circuit finds basis in rights created from the collapse of the savings and loan industry in the 1970s: the hell with § 362(b).** Washington Mutual, Inc. v. United States, 636 F.3d 1207 (9th Cir. 3/3/11). The taxpayer, as the successor corporation to Home Savings of America, filed a refund action claiming amortization deductions for certain rights, and loss deductions for abandonment of branching rights, created in a § 368(a)(1)(G) reorganization by the Federal Savings and Loan Insurance Corporation (FSLIC) in which Home Savings acquired three failed savings

and loan associations. The District Court granted summary judgment to the IRS, concluding that Home Savings had no basis in the rights. The Ninth Circuit reversed and remanded, disagreeing with the District Court's conclusion regarding basis. As part of the acquisition of the three failed thrifts in a supervisory merger transaction structured as a type G reorganization, FSLIC entered into an "Assistance Agreement" with Home Savings that included, among other things, approval for Home Savings to establish branches in Florida and Missouri as if Home Savings maintained its home office in those states, and approval of the purchase method of accounting under which Home Savings was permitted to apply a percentage of acquired intangible assets in its deposit base and for amortization of the remainder over forty years. The Ninth Circuit accepted the taxpayer's argument and concluded that the excess of liabilities of the acquired thrifts over the value of assets represented a cost that was consideration for the rights represented in the Assistance Agreement in the integrated transaction, and concluded that allowing the taxpayer a cost basis was not inconsistent with characterizing the transaction as a § 368(a)(1)(G) reorganization, notwithstanding the transferred basis rule of § 362(b). The Court rejected the IRS's assertion that "recognizing Home Savings a cost basis in the Rights based on the assumption of FSLIC's liabilities requires characterizing some of the acquired thrifts' liabilities as FSLIC's liabilities, because Home Savings did not pay FSLIC or the Bank Board separate consideration for the Rights." The District Court concurred with the IRS's position, holding that the excess liabilities of the acquired thrifts were the same as FSLIC's insurance liabilities, which remained liabilities of FSLIC. The Ninth Circuit reasoned that Home Savings received a generous incentive package, the cost of which was the excess of the failing thrifts' liabilities over the value of their assets. A concurring opinion argued that the acquired rights had a fair market value basis as acquired directly from FSLIC in exchange for taking over the liabilities of the failed thrifts. The Ninth Circuit remanded the case to the District Court to determine the proper amortization amounts for the intangibles and the amount of abandonment loss for the branch rights.

**a. On remand, the taxpayer fails to establish the amount of its cost basis for the intangibles and fails to demonstrate that it abandoned the branch rights.** Washington Mutual, Inc. v. United States, 996 F. Supp. 2d 1095 (D. Wash. 2/10/14). On remand from the Ninth Circuit, the District Court determined that the taxpayer failed to establish its cost basis in the rights that it acquired through the incentive package it received from the FSLIC as part of the supervisory merger. For this reason, the court concluded, the taxpayer could not take amortization or loss deductions with respect to the rights. Under the approach dictated by the Ninth Circuit, the amount the taxpayer paid for the rights was equal to the excess of

the failing thrifts' liabilities over the value of their assets. The taxpayer conceded that the total fair market value of the rights it received was greater than the amount the taxpayer paid for them. The District Court reasoned that, in order to allocate the purchase price among the rights the taxpayer received, the taxpayer had to establish the fair market value of *each* right the taxpayer received. The court concluded that the taxpayer failed to establish, to a reasonable degree of certainty, the value of one of the rights (the "Missouri Branching Right"), which gave the taxpayer the right to open branches in Missouri. The court agreed with the government that the discounted cash flow valuation model used by the taxpayer's expert was too flawed to form a reliable basis for valuing the Missouri Branching Right.

- The court also concluded that the taxpayer had not established that it abandoned the Missouri Branching Right. Accordingly, even if it had established its cost basis, the taxpayer was not entitled to a loss deduction with respect to this right. The taxpayer sold or exchanged its Missouri deposit-taking branches, entered into covenants not to compete, and notified stock analysts, shareholders, and the Office of Thrift Supervision that it was closing its Missouri branches. Nevertheless, the court determined that the taxpayer failed to demonstrate that it was permanently surrendering its right to purchase and operate branches in Missouri.

**2. Just because it's a tax-free merger for income tax purposes doesn't mean it's free of gift taxes.** Cavallaro v. Commissioner, T.C. Memo. 2014-189 (9/17/14). The taxpayers owned a contract manufacturing corporation (Knight) that made tools and machine parts. One of their sons developed an automated liquid-dispensing machine they called CAM/ALOT. Three of their sons (including the inventor) owned Camelot Systems, Inc., a business dedicated to the sale of the CAM/ALOT machines, which were manufactured by Knight. The two companies operated out of the same building, shared payroll and accounting services, and collaborated in further development of the CAM/ALOT product line. Knight funded the operations of both companies and paid the salaries and overhead costs for both. Pursuant to advice of an estate planning lawyer, the taxpayers and their sons merged Knight, with Camelot as the surviving entity. Based on the values of the two corporations, the taxpayers received a disproportionately low number of shares in the new corporation and their sons received a disproportionately high number of shares. The Tax Court (Judge Gustafson) held that the Camelot shares that the taxpayers received in the merger in exchange for their shares of Knight were not full and adequate consideration. Accordingly, they had made a \$29.6 million gift to their sons as a result of the merger. Accuracy and failure

to file penalties were not upheld because the taxpayers relied in good faith on the advice of tax professionals regarding the valuation of the two companies.

**3. The IRS eliminates the elective location of E&P in tax-free reorganizations.** T.D. 9700, Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another; Acquiring Corporation for Purposes of Section 381, 79 F.R. 66616 (11/10/14). The IRS and Treasury have finalized proposed amendments to Reg. § 1.381-1(a), REG-131239-13, Acquiring Corporation for Purposes of Section 381, 79 F.R. 26190 (5/7/14), and to Reg. § 1.312-11, REG-141268-11, Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another, 77 F.R. 22515 (4/16/12). As amended, Reg. § 1.381(a)-1(b)(2) provides that for purposes of determining the corporation that succeeds to the target corporation's tax attributes in a tax-free reorganization, the acquiring corporation is the corporation that, pursuant to the plan of reorganization, directly acquires the assets transferred by the transferor corporation, even if that corporation ultimately retains none of the assets so transferred. According to the Preamble to the proposed regulations:

The [prior] regulations under section 381 yield an identical result, except when a single controlled subsidiary of the direct transferee corporation acquires all of the assets transferred by the transferor corporation pursuant to a plan of reorganization. In that case, the [prior] regulations treat the subsidiary as the acquiring corporation, a result that effectively permits a taxpayer to choose the location of a transferor corporation's attributes by causing the direct transferee corporation either to retain or not to retain a single asset. The IRS and the Treasury Department believe the [amended provision] produces more appropriate results because it . . . eliminate[s] the electivity.

As amended, Reg. § 1.312-11 merely cross-references the § 381 regulations.

**4. Tracking the basis of nonexistent stock ain't easy.** T.D. 9702, Allocation of Basis in All Cash D Reorganizations, 79 F.R. 67059 (11/12/14). The Treasury Department has promulgated final regulations replacing Temp. Reg. § 1.358-2T (T.D. 9558, Corporate Reorganizations; Allocation of Basis in "All Cash D" Reorganizations, 76 F.R. 71878 (11/21/11)) with only nonsubstantive changes. Reg. § 1.358-2 deals with stock basis in all cash type D reorganizations under Reg. § 1.368-2(1). If an actual shareholder of the acquiring corporation is deemed to receive a nominal share

of stock of the issuing corporation described in Reg. § 1.368-2(l), that shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of Reg. § 1.358-1, and after adjusting the basis in the nominal share for any transfers described in Reg. § 1.358-1, designate the share of stock of the acquiring corporation to which the basis, if any, of the nominal share will attach. Under these rules, the ability to designate the share of stock of the acquiring corporation to which the basis of the surrendered stock or securities of the target will attach applies only to a shareholder that actually owns shares in the issuing corporation. Thus, for example, if in an all cash type-D reorganization, Y Corporation, a first tier subsidiary of P Corporation, acquires the assets of T Corporation, a second tier subsidiary of P Corporation, owned by X Corporation, a first tier subsidiary of P Corporation, X Corporation cannot designate any share of Y Corporation stock to which the basis, if any, of the nominal share of Y Corporation stock will attach; and P Corporation cannot designate a share of Y Corporation stock to which basis will attach because P Corporation's basis in the nominal share of Y Corporation stock (deemed to have been distributed to it by X Corporation) is zero (its fair market value).

#### **F. Corporate Divisions**

There were no significant developments regarding this topic during 2014.

#### **G. Affiliated Corporations and Consolidated Returns**

**1. The Eleventh Circuit interprets a tax-sharing agreement. You don't often see cases like this.** *Zucker v. FDIC*, 727 F.3d 1100 (11th Cir. 8/15/13). This case involved the interpretation of a tax sharing agreement (TSA) among members of a consolidated group. The TSA provided that although the parent holding company would file the group's tax return, a bank subsidiary would pay all income taxes for the group and receive contributions from other members of the group, and the bank would pay any member of the group that member's share of any refund. The day after the bank was closed and the FDIC appointed its receiver, the holding company filed for Bankruptcy Act Chapter 11 protection. Subsequently, the holding company received a refund, which it treated as part of the bankruptcy estate rather than paying it to the FDIC (as the bank's successor) for distribution pursuant to the TSA. The Eleventh Circuit, in an opinion by Judge Tjoflat, reversed the Bankruptcy Court and held that the refund was not part of the holding company's bankruptcy estate; the refund was to be paid over to the FDIC for distribution to the group's members in accordance with the TSA.

Interpreting the TSA contract under the controlling Delaware law, the court found that although the TSA did not contain a provision expressly requiring the holding company to forward the tax refunds to the bank, that was what the parties intended. Thus, the court concluded:

The relationship between the Holding Company and the Bank is not a debtor-creditor relationship. When the Holding Company received the tax refunds, it held the funds intact—as if in escrow—for the benefit of the Bank and thus the remaining members of the Consolidated Group. The parties intended that the Holding Company would promptly forward the refunds to the Bank so that the Bank could, in turn, forward them on to the Group’s members. In the Bank’s hands, the tax refunds occupied the same status as they did in the Holding Company’s hands—they were tax refunds for distribution in accordance with the TSA.

**a. Well, well, maybe you do see these cases more than we thought.** Federal Deposit Insurance Corp. v. Amfin Financial Corp., 757 F.3d 530 (6th Cir. 7/8/14). Amfin Financial was the parent of a consolidated group that included AmTrust Bank. Amfin Financial, which was in bankruptcy, argued that the group’s tax-sharing agreement mandated that a \$170 million tax refund generated by AmTrust’s net losses belonged to Amfin Financial’s bankruptcy estate, and that AmTrust was merely a creditor of the estate. The district court agreed, holding that the tax-sharing agreement unambiguously allocated the refund to Amfin Financial. The Sixth Circuit reversed because it concluded that the tax-sharing agreement was silent on this issue, and remanded the case with instructions that the district court consider extrinsic evidence concerning the parties’ intent in light of Ohio agency and trust law.

**2. Self-help for subsidiaries that fail to consent to the consolidated return regulations by filing Form 1122.** Rev. Proc. 2014-24, 2014-13 I.R.B. 879 (3/10/14). This revenue procedure provides guidance on the conditions that must be satisfied to obtain an automatic determination that a subsidiary member of an affiliated group will be treated as if it had filed Form 1122, Authorization and Consent of Subsidiary Corporation to Be Included in a Consolidated Income Tax Return, and thus joined in the group’s making of a consolidated return, notwithstanding the subsidiary’s failure to file Form 1122. An affiliated group of corporations can elect to file a consolidated return only if each corporation that is a member of the affiliated group for any portion of the group’s tax year consents to the consolidated return regulations. Reg. § 1.1502-75(a)(1). For the first tax year in which the

group files a consolidated return, each subsidiary group member must give this consent by filing Form 1122. Reg. § 1.1502-75(b)(1), (h)(2). If a subsidiary fails to file Form 1122, it is treated as if it had filed Form 1122 if the IRS determines that the subsidiary joined in the consolidated return or that the subsidiary was excluded due to a mistake of law or fact, or to inadvertence. Reg. § 1.1502-75(b)(2)-(3). The IRS no longer issues private letter rulings (but may issue determination letters) on whether a subsidiary group member will be treated as if it had filed Form 1122. *See* Rev. Proc. 2014-3, § 3.01(73), 2014-1 I.R.B. 111 (12/30/13). To mitigate the inability of taxpayers to obtain certainty through private letter rulings, the revenue procedure provides that, if certain conditions are satisfied, “it is hereby determined by the Commissioner that a subsidiary that actually failed to file a Form 1122 (non-filing subsidiary) is treated as if it filed Form 1122 and thus joined in the making of a consolidated return by the affiliated group.” The conditions are: (1) The affiliated group timely filed what purported to be a consolidated return for the year, including Form 851 (Affiliations Schedule) or provided some other clear and unequivocal indication on the return that it was intended as a consolidated return; (2) The non-filing subsidiary was not prevented from joining in the filing of the consolidated return by any applicable rule of law, other than the failure to file Form 1122; (3) With certain limited exceptions, the non-filing subsidiary did not file a separate return for any period of time included in the consolidated return, or any subsequent taxable year; and (4) One of three specified conditions exists, which generally require that (a) the failure to file Form 1122 was either due to a mistake of law or fact, or to inadvertence, or caused by the group’s belief that the non-filing subsidiary was treated as a partnership, and (b) the non-filing subsidiary’s income and deductions were included in the consolidated return. An affiliated group that does not satisfy the requirements for an automatic determination can seek a determination letter. The revenue procedure was effective March 24, 2014.

## H. Miscellaneous Corporate Issues

**1. Tacking a farm or ranch subsidiary onto your personal services corporation might enable you to beat the flat rate 35-percent corporate tax.** Applied Research Associates, Inc. v. Commissioner, 143 T.C. No. 17 (10/9/14). The taxpayers were an affiliated group that filed consolidated returns. The group consisted of a parent that provided professional engineering services, and thus was a qualified personal service corporation, and a subsidiary that conducted a ranching business, and thus was not a qualified personal service corporation. All of the group’s consolidated taxable income for the years in question was attributable to the parent personal service corporation. The taxpayer took the position that the group, as a single

entity, was not a qualified personal service corporation and computed the tax on its consolidated taxable income using the § 11(b)(1) graduated rates. The IRS took the position that each group member's status as a qualified personal service corporation should be determined separately and calculated the tax on the consolidated taxable income of the group under the § 11(b)(2) flat 35-percent tax rate applicable to qualified personal service corporations. The Tax Court (Judge Jacobs) held that the graduated rates schedule in § 11(b)(1) applied to compute the tax owed by an affiliated group consisting of a qualified personal service corporation and that an entity that is not a qualified personal service corporation where the group, as a single entity, was not a personal service corporation. The court rejected the IRS's argument that "where one member of an affiliated group is a qualified personal service corporation and another is not, the consolidated taxable income of the affiliated group must be broken up into two separate baskets"; "that section 448 requires that the determination as to whether a corporation is a qualified personal service corporation is to be made at the entity level, not at the level of the affiliated group." Rather, the court found "no authority to permit the breakup of an affiliated group's consolidated taxable income into separate baskets." It looked at "the affiliated group as a whole, i.e., the entity which generated the consolidated taxable income, to determine the characterization of the consolidated taxable income." When viewed as a whole, the group was not a qualified personal service corporation.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

1. **Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2, but it was too late to keep the Miss America Pageant in Atlantic City.** Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events, and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to

nineteen large corporations, which described the transaction as a “sale” of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about \$57 million to Historic Boardwalk Hall and Pitney Bowes made capital contributions of more than \$18 million to that LLC, as well as an investor loan of about \$1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a “development fee” and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

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

- Query whether “economic substance” requirements are applicable when the tax benefits take the form of tax credits enacted to encourage specific types of investments?

a. “[T]he sharp eyes of the law’ require more from parties than just putting on the ‘habiliments of a partnership whenever it advantages them to be treated as partners underneath.’ . . . Indeed, *Culbertson* requires that a partner ‘really and truly intend[] to . . . shar[e] in the profits and losses’ of the enterprise. . . . And, after looking to the substance of the interests at play in this case, we conclude that, because Pitney Bowes lacked a meaningful stake in either the success or failure of Historic Boardwalk Hall, it was not a bona fide partner.” *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 8/27/12), cert. denied, 133 S. Ct. 2734 (5/28/13). In a unanimous opinion by Judge Jordan, the Third Circuit reversed the Tax Court and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall, LLC. The court’s reasoning was based on the *Culbertson* test [*Commissioner v. Culbertson*, 337 U.S. 733 (1949)], as applied by the Second Circuit in *TIFD*

*III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (*Castle Harbour II*), to find that the Dutch banks were not partners, and the reasoning of the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), to find that the investors who acquired the Virginia Historic Rehabilitation credits through the partnership bore no “true entrepreneurial risk,” which the Third Circuit concluded was a characteristic of a true partner under the *Culbertson* test. The Third Circuit concluded that Pitney Bowes was not a partner because, based on an analysis of the facts, as the transaction was structured, (1) Pitney Bowes “had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought — the HRTCs or their cash equivalent,” and (2) Pitney Bowes’s “avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential.” The analysis was highly factual and based on substance over form. As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court’s finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3 percent preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund*, the Third Circuit treated the 3 percent preferred return as a “return on investment” that was not a “share in partnership profits,” which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that “although in form PB had the potential to receive the fair market value of its interest . . . in reality, PB could never expect to share in any upside.” The court noted that it was mindful “of Congress’s goal of encouraging rehabilitation of historic buildings,” and that its holding might “jeopardize the viability of future historic rehabilitation projects,” but the court observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

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

**b. The IRS is gilding the lily of its *Historic Boardwalk* victory.** *Historic Rehabilitation Partnership a Sham, IRS Concludes*, 2013 TAX NOTES TODAY 41-18 (10/5/12). This Field Attorney Advice dealt with whether a taxpayer was a partner in a partnership that generated § 47 historic rehabilitation tax credits. The FAA held that under the *Culbertson* doctrine, as applied in *Castle Harbour*, the taxpayer was not a partner. The taxpayer had no meaningful downside risk in that it was assured of receiving the benefit of its bargain, and it had no upside potential. All it

could receive was its specified priority return. Alternatively, the purported partnership was a sham; it served no business purpose. Its only purpose was to effect a sale of the rehabilitation tax credits to the taxpayer. *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), which held that a sale-leaseback transaction involving solar energy equipment had economic substance even though the investment had a negative rate of return before taking into account tax benefits, was distinguished on the ground that the transaction at issue in *Sacks* otherwise had economic substance in terms of risk and reward. In reaching the conclusion, the FAA states as follows:

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

- This position is absurd because the purpose of tax credits is to encourage taxpayers to engage in otherwise unprofitable activities. A holding that an activity that is unprofitable before taking tax credits into consideration lacks economic substance defeats that purpose.

**c. The IRS now provides a Safe Harbor under which it will not use its *Historic Boardwalk* victory to challenge allocations of § 47 rehabilitation credits to investor partners.** Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (12/31/13). This revenue procedure specifies the conditions under which the IRS will not challenge partnership allocations of § 47 rehabilitation credits. Section 4 of the revenue procedure contains the

requirements for the Safe Harbor. It defines investors as partnership partners (other than principals) (§4.01); provides for an investor's minimum partnership interest (§4.02); provides for an investor's minimum unconditional contribution of 20 percent of the investor's total expected capital contribution before the date the building is placed in service (§4.03); and requires that at least 75 percent of the investor's total expected capital contribution be fixed in amount before the building is placed in service (§4.04).

- The fly in the ointment is that the investor's interest must be a "bona fide equity interest."

**2. Even though living on credit is as American as apple pie, there's still no increase in the basis of a partnership interest when the partner contributes his own promissory note to the partnership.** VisionMonitor Software, LLC v. Commissioner, T.C. Memo. 2014-182 (9/3/14). The sole issue in this case was whether the contribution to a partnership of a partner's promissory note gave rise to an increase in the partner's basis in the partnership interest under § 722, which would allow partnership level losses to pass through to the partners. Following prior Tax Court precedent, Judge Holmes upheld the IRS's long-standing position that the contribution of a partner's own note to the partnership isn't the equivalent of a contribution of cash, Revenue Ruling 80-235, 1980-2 C.B. 229, and without more, it will not increase the partner's basis in the partnership interest. *Dakotah Hills Offices Ltd. P'ship v. Commissioner*, T.C. Memo. 1998-134 (no increased basis because not cash equivalent and not property in which partner has basis); *Gemini Twin Fund III v. Commissioner*, T.C. Memo. 1991-315 (partner's outside basis not increased by contribution of promissory note), *aff'd without published opinion*, 8 F.3d 26 (9th Cir. 1993); *Oden v. Commissioner*, T.C. Memo. 1981-184 (partner has zero basis in own promissory note), *aff'd without published opinion*, 679 F.2d 885 (4th Cir. 1982). The court rejected the taxpayer's argument that *Gefen v. Commissioner*, 87 T.C. 1471 (1986), supported the argument that the contribution of a partner's own note to the partnership increases the partner's basis in the partnership interest. In *Gefen*, a partner acquired an interest in a limited partnership and executed a limited guaranty under which the partner assumed personal liability to the partnership's existing creditor for her pro rata share of the partnership's recourse indebtedness to that creditor. Pursuant to Reg. § 1.752-1(e), the partner in *Gefen* was entitled to increase her basis in the partnership by the specific amount of the partnership's recourse debt that she personally assumed under the terms of this guaranty. However, accuracy-related penalties were not sustained; the taxpayer in good faith relied on an experienced tax advisor that the court found to be competent.

- The court does not discuss contrary authority in an analogous situation in the corporate context. Section 357(c)

requires recognition of gain in an exchange that otherwise qualifies for nonrecognition under § 351 or § 361 if the taxpayer transfers property and the liabilities assumed in the exchange exceed the taxpayer's adjusted basis in the property. Some courts have held that a taxpayer who transfers encumbered property to a corporation in exchange for stock can avoid recognizing gain under § 357(c) by contributing the taxpayer's promissory note for an amount at least equal to the amount by which the liabilities assumed exceed the taxpayer's basis in the property transferred. *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998) (holding that taxpayer has basis in his own promissory note); *see also Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989) (holding that corporation had basis in the contributed promissory note, which was sufficient for the taxpayer contributing the property and note to avoid gain under § 357(c)).

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

[T]he parties, to form a valid tax partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share 'the profits and losses.' If the parties lack either intent, then no valid tax partnership has been formed.

The court rejected Dow's argument that a determination of whether an interest qualifies as debt or equity must precede addressing whether under *Culbertson* the partnership is a sham, and that the foreign banks were partners rather than creditors because they were "not legally entitled to repayment of their

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

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

**1. Proposed regulations allocate liabilities among multiple parties and among related parties.** REG-136984-12, Section 752 and Related Party Rules, 78 F.R. 76092 (12/16/13). The IRS has proposed regulations to address allocation of the risk of economic loss for purposes of allocating partnership liabilities to a partner’s basis. Under Reg. § 1.752-2(a), a partner is allocated a share of recourse liability to the extent that the partner or a related person bears the economic risk of loss. A liability is nonrecourse when no partner or related person bears an economic risk of loss.

- *Multiple Parties.* Under Prop. Reg. § 1.752-2(a)(2), where multiple partners bear the economic risk of loss with respect to the same liability, the amount of the liability will be taken into account only once, and if the total amount of liability borne by the partners exceeds the amount of the liability, the economic risk of loss to be borne by each partner would be determined by multiplying the amount of the liability by a fraction determined by dividing the amount of the economic risk of loss of a partner over the sum of the amount of loss borne by all partners. Thus, as illustrated by an example in the proposed regulations, where partner A guarantees the full \$1,000 of a bank loan to the AB partnership and partner B guarantees \$500 of the liability, the amount of the liability allocable to A is \$667 ( $\$1,000 \times \$1,000/\$1,500$ ), and the amount

of the liability allocable to B is \$333 ( $\$1,000 \times \$500/\$1,500$ ). Prop. Reg. § 1.752-2(i) would be amended to provide that where a liability of a lower-tier partnership is allocated both to the upper-tier partnership and to a partner who bears economic risk of loss as a partner in both the upper-tier and lower-tier partnerships, the basis resulting from such a liability will be allocated directly to the partner of the lower-tier partnership rather than to the upper-tier partnership.

- *Related Persons.* Under Reg. § 1.704-4(b)(1), an individual and a corporation are treated as related persons if the individual is an 80 percent or greater shareholder. Where the corporation is a lender to a partnership or has a payment obligation with respect to a partnership liability, Prop. Reg. § 1.752-4(b)(1)(iv) would disregard the application of § 267(c)(1) that provides that stock owned by a partnership is treated as owned proportionately by its partners. As a result, a partner in a partnership that owns 80 percent of the stock of the corporate lender will not be treated as related to the corporation that bears the economic risk of loss. Prop. Reg. § 1.752-4(b)(2) would provide that if a person who is a lender or has a payment obligation for a partnership liability is related to more than one partner, the liability will be shared equally among the related partners. This rule revises the existing provision that allocates the liability to the partner with the highest percentage of related ownership. In addition, the rule of Reg. § 1.752-4(b)(2)(iii), which provides that persons owning interests in the same partnership are not treated as related persons for purposes of determining economic risk for partnership liabilities would be modified to apply only to persons who bear the economic risk for a liability as a lender or have a payment obligation for the partnership liability.

- The proposed regulations are to be effective on the date final regulations are published in the Federal Register.

**2. The shot at guarantees of partnership debt heard ‘round the world, a.k.a. bottom dollar guarantee regulations. Although the proposed regulations are titled “Section 707 Regarding Disguised Sales, Generally,” they should have been titled “Radically Changing Partnership Debt Allocations Under Section 752 and Tweaking the Section 707 Disguised Sales Rules.”** REG-119305-11, Section 707 Regarding Disguised Sales, Generally, 79 F.R. 4826 (1/30/14). The Treasury and IRS have published proposed amendments to the regulations under § 707(a)(2)(B), relating to disguised sales, and § 752, relating to the treatment of partnership liabilities.

- *Disguised Sales Rules:* The proposed regulations under § 707 provide a number of not particularly controversial clarifications of the § 707 disguised sale rules. (1) An ordering rule would be added in Reg. § 1.707-5 to provide that the treatment of a transfer should first be determined under the debt-financed distribution exception, and any amount not

excluded from Reg. § 1.707-3 under the debt financed distribution exception should be tested to see if such amount would be excluded from Reg. § 1.707-3 under a different exception in Reg. § 1.707-4. (2) The exception for preformation capital expenditures in Reg. § 1.707-4 would be clarified to provide expressly that the 20 percent of fair market value ceiling and the exception to the limitation where the fair market value of the property does not exceed 120 percent of basis apply property-by-property. In addition, for purposes of Reg. § 1.707-3, the term “capital expenditures” would have the same meaning as the term “capital expenditures” generally does, *except* that it would include capital expenditures taxpayers elect to deduct, and would not include deductible expenses taxpayers elect to treat as capital expenditures. The proposed regulations also provide a rule coordinating the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures. (3) The proposed regulations add to the list of qualified liabilities that pursuant to Reg. § 1.707-5 may be assumed without triggering the disguised sale rules liabilities that were not incurred in anticipation of the transfer of the property to a partnership, but that were incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred (other than assets that are not material to a continuation of the trade or business). (4) The proposed regulations clarify the anticipated reduction rule in Reg. § 1.707-5(a)(3) by providing that a reduction that is subject to the entrepreneurial risks of partnership operations is not an anticipated reduction. (5) The proposed regulations add additional rules regarding tiered partnerships. (6) The proposed regulations extend the netting of partners’ increases and decreases of liabilities principles of Reg. § 1.752-1(f) to determine the effect of a partnership merger under the disguised sale rules.

- *Partners’ Shares of Recourse Debt:* For purposes of allocating partnership liabilities generally, Reg. § 1.752-2 adopts an ultimate liability test under a worst-case scenario. Under this test, an otherwise nonrecourse liability of the partnership is allocated as a recourse liability to a partner that guarantees the liability, even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability with either partnership profits or capital. The IRS and the Treasury Department consider that approach inappropriate due to the fact that in most cases, a partnership will satisfy its liabilities with partnership profits, the partnership’s assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The IRS and the Treasury Department believe that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner. Accordingly, the proposed amendments to Reg. § 1.752-2 provide that obligations to make a payment with respect to a partnership liability (excluding those imposed by state law) will not be recognized for purposes of § 752 unless certain factors are present. These factors

are intended to ensure that the terms of the payment obligation are not designed solely to obtain tax benefits. First, a partner or related person must (a) maintain a commercially reasonable net worth during the term of the payment obligation or (b) be subject to commercially reasonable restrictions on asset transfers for inadequate consideration. Second, the partner or related person must provide commercially reasonable documentation regarding its financial condition. Third, the payment obligation must not terminate prior to the term of the partnership liability. Fourth, the primary obligor or any other obligor must not be required to hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor. Fifth, the partner or related person must receive arm's length consideration for assuming the payment obligation. Sixth, in the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Seventh, in the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is, or would be, liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied. (The sixth and seventh rules do not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.) These rules would prevent certain so-called "bottom dollar" guarantees from being recognized for purposes of § 752. The proposed regulations relating to guarantees and indemnities draw lines that, among other things, preclude recognition of a payment obligation for a portion, rather than 100 percent, of each dollar of a partnership liability to which the payment obligation relates. The proposed regulations provide the following example with respect to top and bottom dollar guarantees:

A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows \$1,000 from Bank. A guarantees payment of up to \$300 of the ABC liability if any amount of the full \$1,000 liability is not recovered by Bank. B guarantees payment of up to \$200, but only if the Bank otherwise recovers less than \$200. Both A and B waive their rights of contribution against each other. . . . Because A is obligated to pay up to \$300 if, and to the extent that, any amount of the \$1,000 partnership liability is not recovered by Bank, A's guarantee satisfies the requirement[s] . . . . Therefore, A's payment obligation is recognized . . . . The amount of A's economic risk of loss . . . is \$300. However, because B is obligated to pay up to \$200 only if and to the extent that the Bank otherwise recovers less

than \$200 of the \$1,000 partnership liability, B's guarantee does not satisfy the requirement[s] . . . and B's payment obligation is not recognized. Therefore, B bears no economic risk of loss . . . for ABC's liability. As a result, \$300 of the liability is allocated to A . . . and the remaining \$700 liability is allocated to A, B, and C under § 1.752-3.

In addition to these seven factors that must be satisfied, if the partner or related party is neither an individual nor a decedent's estate, that partner or related party's payment obligation will be recognized only to the extent of the partner's or related person's net value as of the allocation date. This rule applies to a payment obligation of a partner or related person that is a disregarded entity, e.g., a single-member LLC (even if the disregarded entity is owned by an individual or a decedent's estate), QSub, etc. In furtherance of this rule, the proposed regulations require a partner or related person (other than an individual or a decedent's estate) to provide information to the partnership regarding that person's net value that is appropriately allocable to the partnership's liabilities. The proposed regulations revise the anti-abuse rule under § 1.752-2(j) to address the use of intermediaries, tiered partnerships, or similar arrangements to avoid the bottom-dollar guarantee rules.

- *Partners' Shares of Nonrecourse Debt:*

Proposed amendments to Reg. § 1.752-3(a)(3) would change the rule for allocating nonrecourse debt not allocated per minimum gain or § 704(c) gain according to partnership profits shares. Under the proposed regulations, the designated profits interest must be in accordance with the partners' liquidation value percentages. That percentage, which is first determined when the partnership is formed, but which must be redetermined from time to time, is "the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership."

- *Effective Date:* The proposed regulations will be effective upon finalization. Taxpayers may not rely on them pending finalization.

### C. Distributions and Transactions Between the Partnership and Partners

#### 1. Transfer of state rehabilitation tax credits is recognized as a partnership contribution and distribution rather than a sale. *Gateway Hotel Partners, LLC v. Commissioner*, T.C. Memo. 2014-5 (1/9/14). Gateway Hotel Partners (GHP) was formed to renovate historic hotel properties in St. Louis, Missouri. GHP's members were WAHD,

a Missouri LLC that was the operating partner and which contracted with GHP as the developer, and HH, a Texas LLC, the passive investor. WAHD was majority owned and managed by HRI, a New Orleans based real estate developer organized as an S corporation. HRI obtained a bridge loan to finance the project from the Missouri Development Finance Board, which was secured by Missouri State Tax Credits that would be issued by the Finance Board on completion of the hotel projects. The loan agreements with the Finance Board and among the various entities required HRI to contribute the bridge loan proceeds to WAHD, which in turn was contractually required to contribute the proceeds to GHP. However, the money was actually paid directly to GHP. HRI had also contracted to sell the tax credits to another party, ultimately using the sales proceeds to repay the bridge loan. In the first two stages, upon completion of the projects, GHP would distribute the tax credits to WAHD, which in turn would distribute the tax credits to HRI for sale to the third party. GHP's financial statements did not reflect the receipt of a capital contribution from WAHD, nor did WAHD's or HRI's financial statements reflect distributions of the tax credits, which went straight to the ultimate purchaser. The IRS asserted that the bridge loans were made directly to GHP so that distributions to WAHD or HRI, or both, were not partnership distributions in redemption of partnership capital interests, but represented sales of the tax credits by GHP, which thereby recognized gain on the sales under the substance over form doctrine, the step transaction doctrine, or under disguised sale principles of § 707(a)(2)(B). The Court (Judge Goeke) agreed with the taxpayer that the transfer of the bridge loan proceeds represented a contribution to capital for a partnership interest in GHP by WAHD, notwithstanding the direct payment from the Finance Board undertaken to obviate the necessity of three separate transfers. Examining the whole transaction, the court concluded that both the form and the substance of the bridge loan established that HRI, not GHP, was the borrower. The court further rejected the IRS's assertion that making the bridge loan to HRI was a meaningless step taken to avoid Federal income tax, in part because HRI's better risk profile permitted it to obtain the bridge loan on better terms than would have been available to GHP. It therefore followed that the transfer of the loan proceeds through WAHD represented a capital contribution to GHP. The court further rejected the IRS's assertion that GHP transferred the tax credits directly to the purchaser as a sale under substance over form and step transaction principles, finding instead that GHP's transfer of the tax credits flowed from WAHD's capital contribution, which was not a meaningless or unnecessary step in the transaction, and therefore constituted a distribution. The court also rejected the IRS's argument that the contribution of loan proceeds by WAHD, followed by distribution of the tax credits, was a disguised sale under § 707(a)(2)(B). Following the direction of Reg. § 1.707-6, the court applied the facts and circumstances rules of Reg. § 1.707-3,

including the presumption that the contribution and distribution to WAHD, which occurred more than two years apart, were not part of a disguised sale. The court analyzed the multiple factors of Reg. § 1.707-3 as follows:

- The authority of the passive partner to determine whether to use cash or property to satisfy WAHD's preferences and uncertainty of amount and timing of distributions meant that the timing and amount of subsequent distributions were uncertain. Reg. § 1.707-3(b)(2)(i).

- The discretion of the passive partner meant that WAHD did not have an enforceable right to the distribution of tax credits. Reg. § 1.707-3(b)(2)(ii).

- The passive partner's discretion to distribute cash or property meant that the rights of WAHD to the money or property were not secured. Reg. § 1.707-3(b)(2)(iii).

- An insurance policy against GHP's receipt of the tax credits did not represent a legal obligation to make contributions to the partnership, which the court interpreted as requiring under Reg. § 1.707-3(b)(2)(iv) an obligation to make a contribution that would provide an equity interest in the partnership. The insurance policy represented an obligation to make a payment in exchange for insurance premiums paid by the partnership.

- The absence of debt incurred or other obligation to incur debt by a third party or the partnership to fund the distribution weighed against disguised sale. Reg. § 1.707-3(b)(2)(v) and (vi).

- The partnership did not have excess liquid assets to fund a distribution. Reg. § 1.707-3(b)(2)(vii).

- The agreements were not designed to transfer ownership rights to the tax credit to WAHD. Reg. § 1.707-3(b)(2)(viii).

- The fact that WAHD had a 1 percent profits interest but received 100 percent of the tax credits indicated that the transfer of tax credits to WAHD bore no relationship to WAHD's interest in GHP profits and thus was a factor indicating disguised sale treatment. Reg. § 1.707-3(b)(2)(ix).

- Also, the fact that WAHD was not required to return the tax credits weighed in favor of disguised sale treatment, Reg. § 1.707-3(b)(2)(x), notwithstanding WAHD's obligation to fund operating deficits, which the court viewed as independent of any requirement to return the tax credits.

- The court was not persuaded that two out of the ten factors indicated a disguised sale, particularly in light of the first two factors, uncertainty about the amount and timing of the distribution, and the absence of an enforceable right to the distribution, which the court found to be the most compelling factors.

- The court found that a third transfer of tax

credits directly from GHP to the purchaser, with the proceeds transferred directly from the purchaser to the Finance Board, that was not documented in the year of the transfer as a distribution, constituted a sale by the partnership.

- The court also held that development fees paid to GHP by WAHD before commencement of operations were a return of principal and therefore not includable in GHP's income.

**2. The ground gave way under the feet of the seismologist's tax avoidance scheme.** Seismic Support Services, LLC v. Commissioner, T.C. Memo. 2014-78 (5/5/14). The individual taxpayer in this case was employed as a seismic design consultant. He formulated a scheme to alter his status as an employee to reduce his wage tax obligations. After his employer refused to treat him as an independent contractor, he formed an LLC, of which he owned 95 percent, through which he provided services as a subcontractor. All of the LLC's income was paid over to the individual taxpayer. The LLC claimed a deduction, but did not file employment tax returns; it described the payments as distributions. The Tax Court (Judge Kroupa) held that the payments from the LLC to the taxpayer were § 707(c) payments for services. The payments were made for services and were determined without regard to the LLC's income. The taxpayer performed all services on behalf of the LLC. There was no basis in the record to conclude the payments were for the use of capital. Because the record reflected that the LLC mischaracterized the payments to enable the taxpayer to avoid partner-level self-employment taxes, and he admitted that he was trying to avoid paying taxes, a § 6662 accuracy-related penalty was upheld.

**3. As if § 751(b) wasn't already hard enough to understand.** REG-151416-06, Certain Distributions Treated as Sales or Exchanges, 79 F.R. 65151 (11/3/14). The IRS and Treasury Department have proposed amendments to the regulations under § 751(b) that would completely change the mechanics of the application of § 751(b) in nonliquidating distributions. Speaking generally, § 751(b), for example, creates a constructive taxable exchange whenever a partner receives a current distribution that alters the partners' respective interests in unrealized receivables or substantially appreciated inventory (§ 751 property). Section 751(b) generally is intended to prevent partners from allocating among themselves the character of the gain recognized from sales of partnership property. As implemented by the current regulations, § 751(b) is deeply flawed because it measures disproportionality by the value of substantially appreciated inventory and accounts receivable rather than by the built-in gain or loss. Thus, it fails to fulfill completely its stated purpose. These proposed regulations are intended to cure that flaw by amending the § 751(b) regulations to operate similarly to the § 751(a)

regulations, which provide generally that a partner's interest in § 751 property is the amount of income or loss from § 751 property that would be allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. Prop. Reg. § 1.751-1(a)(2). The hypothetical sale approach in the proposed § 751(b) regulations, like the approach in the 1999 § 751(a) regulations, shifts the focus away from gross value and to tax gain and loss. Under the hypothetical sale approach, a partner's interest in § 751 property is determined by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property for fair market value immediately before the distribution. The hypothetical sale approach (applying § 704(c) principles) compares: (1) the amount of ordinary income that each partner would recognize if the partnership sold all of its property for fair market value immediately before the distribution, with (2) the amount of ordinary income each partner would recognize if the partnership sold all of its property (and the distributee partners sold the distributed assets) for fair market value immediately after the distribution. Prop. Reg. § 1.751-1(b)(2). If the distribution reduces the amount of ordinary income (or increases the amount of ordinary loss) from § 751 property that would be allocated to, or recognized by, a partner (thus reducing that partner's interest in the partnership's § 751 property), the distribution triggers § 751(b). To make this method work, Reg. § 1.704-1(b)(2)(iv)(f) would be amended to require revaluations of partnership property if the partnership distributes money or other property to a partner as consideration for an interest in the partnership and the partnership owns § 751 property immediately after the distribution. The preamble describes the recognition rules as follows:

If § 751(b) applies to a distribution, each partner must generally recognize or take into account currently ordinary income equal to its "§ 751(b) amount." If a partner has net § 751 unrealized gain both before and after the distribution, then the partner's § 751(b) amount equals the partner's net § 751 unrealized gain immediately before the distribution less the partner's net § 751 unrealized gain immediately after the distribution. If a partner has net § 751 unrealized loss both before and after the distribution, then the partner's § 751(b) amount equals the partner's net § 751 unrealized loss immediately after the distribution less the partner's net § 751 unrealized loss immediately before the distribution. If a partner has net § 751 unrealized gain before the distribution and net § 751 unrealized loss after the distribution, then the partner's § 751(b) amount equals the sum of the partner's net § 751 unrealized gain immediately before the distribution and

the partner's net § 751 unrealized loss immediately after the distribution.

However, this description of the "hot asset sale approach" belies the flexibility and complexity provided by the proposed regulations. An alternative to the "hot asset sale approach" is a "deemed gain" approach, described in the preamble as an approach under which

a § 751(b) distribution results in: (1) the partnership recognizing ordinary income in the aggregate amount of each partner's reduction in the partner's interest in § 751 property, (2) the partnership allocating ordinary income to the partner or partners whose interest in § 751(b) property was reduced by the distribution, and (3) the partnership making appropriate basis adjustments to its assets to reflect its ordinary income recognition.

The deemed gain approach can require recognition of capital gain in certain cases. Rather than choosing between the alternatives, the IRS and Treasury punted, and the proposed regulations do not require the use of a particular approach for determining the tax consequences of a § 751(b) distribution. Rather, the proposed regulations provide that if, under the hypothetical sale approach, a distribution reduces a partner's interest in the partnership's § 751 property, giving rise to a § 751(b) amount, then the partnership must use a reasonable approach that is consistent with the purpose of § 751(b) to determine the tax consequences of the reduction. Generally, a partnership must use one approach consistently (including after a termination of the partnership under § 708(b)(1)(B)). Examples illustrate situations in which the approach adopted is § 1.752-1(b)(2) of the proposed regulations for purposes of determining partner's interest in the partnership's reasonable and in which it is not reasonable. The proposed regulations include extensive provisions dealing with the impact of §§ 734(b) and 743(b) basis adjustments, both those that pre-exist the distribution that triggers § 751(b) as well as those that arise from the distribution. The proposed regulations require a distributee partner to recognize capital gain to the extent necessary to prevent the distribution from triggering a basis adjustment under § 734(b) that would reduce other partners' shares of net unrealized § 751 gain or loss. The proposed regulations also allow distributee partners to elect to recognize capital gain in certain circumstances to avoid § 732 decreases to the basis of distributed § 751 property. (We are not masochistic enough to attempt to describe in detail all of those rules herein.) The proposed regulations also contain complex anti-abuse rules that apply when a partner engages in a transaction that relies on § 704(c) to eliminate or

reduce ordinary income. All of the rules in the proposed regulations are beyond comprehension without reference to the numerous examples.

- The proposed regulations apply to distributions occurring in any taxable period ending on or after the date of publication of final regulations. However, a partnership and its partners may rely on Prop. Reg. § 1.751-1(b)(2) for purposes of determining a partner's interest in the partnership's § 751 property on or after 11/3/14, provided the partnership and its partners apply each of Prop. Regs. §§ 1.751-1(a)(2), 1.751-1(b)(2), and 1.751-1(b)(4) consistently for all partnership distributions and sales or exchanges (including for any distributions and sales or exchanges the partnership makes after a termination of the partnership under § 708(b)(1)(B)).

#### **D. Sales of Partnership Interests, Liquidations, and Mergers**

**1. No bingo for Mingo! Former PwC consultant was required to recognize ordinary income attributable to her interest in partnership unrealized receivables on her receipt of convertible promissory notes in connection with the sale of the PwC consulting business to IBM.** *Mingo v. Commissioner*, T.C. Memo. 2013-149 (6/12/13). The taxpayer was a partner in the management consulting and technology services business (consulting business) of PwC until PwC sold its consulting business to IBM. The sale was structured by PwC transferring its consulting business to a newly formed partnership, PwCC, the partners of which were subsidiaries of PwC. Among the assets PwC transferred to PwCC were its consulting business' uncollected accounts receivable for services it had previously rendered (unrealized receivables). PwC then transferred to each of the 417 consulting partners an interest in PwCC and cash in exchange for the partner's interest in PwC. The taxpayer was one of the partners who received a partnership interest in PwCC and cash from PwC in exchange for her partnership interest in PwC. Then the PwC subsidiaries sold their interests in PwCC to IBM, and the 417 consulting partners sold their interests in PwCC to IBM in exchange for convertible promissory notes. The value of the taxpayer's partnership interest in PwCC was \$832,090, of which \$126,240 was attributable to her interest in partnership unrealized receivables, which were uncollected accounts receivable for services. The taxpayer reported her entire gain on the sale under the § 453 installment method, but the IRS asserted a deficiency on the ground that the gain on the § 751(c) unrealized receivables was not eligible for installment reporting. The Tax Court (Judge Paris) held that § 453 installment reporting is not available for gains attributable to § 751(c) unrealized receivables that represent uncollected cash-method accounts receivable for services. The court relied on *Sorensen v. Commissioner*, 22 T.C. 321 (1954), which held that installment reporting was not available with respect to the sale of options to purchase stock that had been

granted as compensation for the taxpayer's services, because "[t]he provisions of section [453] relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services."

- Furthermore, the IRS's determination that the gain attributable to the unrealized receivables was not eligible for § 453 installment sale reporting, after the taxpayer had reported on the installment method, was a change of accounting method subject to § 481(a). As a result the court sustained the IRS's adjustment for the year 2003, the year the IRS initiated the change, even though the gain properly was reportable in 2002, the year of the sale. The court cited *Bosamia v. Commissioner*, 661 F.3d 250 (5th Cir. 2011), *aff'g* T.C. Memo. 2010-218, for the principle that a § 481(a) adjustment may include amounts attributable to tax years outside the statute of limitations on assessments.

- Finally, because the taxpayer was required to recognize \$126,240 of ordinary income relating to partnership unrealized receivables in 2003, the taxpayer was entitled to increase the basis of the note by that amount, which reduced the reported long-term capital gain for the year in which the note was satisfied by conversion into IBM stock.

**a. The Fifth Circuit affirms—still no bingo for Mingo.** *Mingo v. Commissioner*, 114 A.F.T.R.2d 2014-6886 (5th Cir. 12/9/14). In an opinion by Judge Graves, the Fifth Circuit affirmed and ruled in favor of the government on the same grounds as the Tax Court. The Fifth Circuit relied on *Sorensen v. Commissioner*, 22 T.C. 321 (1954) and held that "the proceeds from the unrealized receivables, classified as ordinary income, do not qualify for installment method reporting because they do not arise from the sale of property." Accordingly, the court held, the taxpayer should have reported ordinary income of \$126,240 in 2002, the year in which she sold her partnership interest. The court also held that the IRS properly changed the taxpayer's method of accounting and made a § 481(a) adjustment with respect to the unrealized receivables in 2003 despite the fact that the limitations period on assessment of tax for 2002 had expired. The court cited its prior opinion in *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568 (5th Cir. 1965) for the proposition that "[t]he Commissioner has ample power to change accounting methods and reassess income for open years; section 481 would be virtually useless if it did not affect closed years."

**2. A partnership termination is only a termination for some purposes.** T.D. 9681, Partnerships; Start-up Expenditures; Organization and Syndication Fees, 79 F.R. 42679 (7/23/14). The Treasury

Department has finalized amendments to Regs. §§ 1.195-2(a), 1.708-1(b)(6), and 1.709-1(b)(3), proposed in REG-126285-12, 78 F.R. 73753 (12/9/13), providing that on a technical termination of a partnership under § 708(b)(1)(B) caused by a sale or exchange of 50 percent or more of partnership interests within a 12-month period, the new partnership deemed to be formed as a continuation of the terminated partnership under Reg. § 1.708-1(b)(4), will continue to amortize § 195 start-up expenses and § 709 organization expenses using the same amortization period adopted by the terminated partnership. The amended regulation clarifies that the terminated partnership may not claim a § 165 loss deduction for any unamortized start-up or organization expenses. The IRS reasoned in the Preamble to the proposed regulations that the technical termination of a partnership under § 708(b)(1)(B) is not a cessation of the trade or business to which the start-up and organizational expenses relate. The Preamble to the proposed regulations also points out that this treatment is consistent with the amortization of § 197 intangibles to the extent of the transferor's adjusted basis, which continues in the new partnership over the remainder of the transferor's 15-year amortization period. The amended regulations apply to technical terminations that occur after 12/9/13.

## E. Inside Basis Adjustments

**1. The IRS continues to strive to make partnership allocations more certain and the rules regarding partnership allocations simultaneously less readable.** REG-144468-05, Disallowance of Partnership Loss Transfers, Mandatory Basis Adjustments, Basis Reduction in Stock of a Corporate Partner, Modification of Basis Allocation Rules for Substituted Basis Transactions, Miscellaneous Provisions, 79 F.R. 3042 (1/16/14). The Treasury Department and IRS have published proposed regulations under §§ 704(c)(1)(C) (dealing with contributed built-in loss property), 734(b) and (d) (dealing with required inside basis adjustments following a distribution by a partnership with a substantial basis reduction), and 743(b) and (d) (dealing with required inside basis adjustments following a transfer of an interest in a partnership with a substantial built-in loss). The proposed regulations also would (1) modify the § 755 basis allocation rules to prevent certain unintended consequences of the current basis allocation rules for substituted basis transactions, and (2) provide additional guidance on allocations resulting from revaluations of partnership property.

- Section 704(c)(1)(C) provides that if property contributed to a partnership has a built-in loss, (1) that built-in loss will be taken into account only in determining the amount of items allocated to the contributing partner, and (2) except as provided by regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership equals its fair market value at the time of

the contribution. The proposed regulations (amendments to Reg. § 1.704-3 and Prop. Reg. § 1.704-3(f)) create a § 704(c)(1)(C) basis adjustment, which initially is equal to the built-in loss associated with the § 704(c)(1)(C) property at the time of contribution and is subsequently adjusted. Under this concept, which is analogous to § 743(b) adjustments in Regs. §§ 1.743-1(j)(1) through (j)(3), the partnership's common basis in the built-in loss property is its fair market value at the time of its contribution. The contributing partner then takes the basis adjustment into account in adjusting, as appropriate, the partner's distributive share of gain, loss, depreciation, or amortization with respect to the property first determined with respect to the common basis. If § 704(c)(1)(C) property is subject to depreciation, § 197 amortization, or another cost recovery method, the § 704(c)(1)(C) basis adjustment associated with the property is recovered in accordance with §§ 168(i)(7), 197(f)(2), or any other applicable provision. Under the proposed regulations, a transferee of a contributing partner's partnership interest does not succeed to the § 704(c)(1)(C) basis adjustment; the share of the § 704(c)(1)(C) basis adjustment attributable to the interest transferred is eliminated. The adjusted partnership basis of § 704(c)(1)(C) property distributed to the contributing partner includes the § 704(c)(1)(C) basis adjustment for purposes of determining any § 734(b) basis adjustment; but § 704(c)(1)(C) basis adjustments are not taken into account in making allocations under Reg. § 1.755-1(c). If § 704(c)(1)(C) property is distributed to another partner, the contributing partner's § 704(c)(1)(C) basis adjustment for the distributed property is reallocated among the remaining items of partnership property under Reg. § 1.755-1(c) (similarly to the rule in Reg. § 1.743-1(g)(2)(ii) for reallocating § 743(b) adjustments). The proposed regulations provide complex rules dealing with complete liquidation of the interest of a partner with respect to whom a § 704(c)(1)(C) adjustment is in effect that are designed to reallocate the basis adjustment among distributed property of the same class if it can be done and to create positive § 734(b) basis adjustments if that cannot be done. There are many other rules dealing with specific transactions (e.g., nonrecognition transfers) involving § 704(c)(1)(C) property. The proposed regulations *do not* extend any of these rules to reverse § 704(c) allocations.

- The proposed regulations under § 734(b) elaborate on the statute principally with respect to tiered partnerships and, in Prop. Reg. § 1.734-2(c), with respect to basis adjustments after a distribution to a contributing partner or a transferee partner.

- The proposed regulations under § 743(b) elaborate on the application of the provision to tiered partnerships and substitute basis provisions and provide detailed rules for the exception for electing investment partnerships.

- Proposed amendments to Reg. § 1.737-1(c) would provide that a § 708(b)(1)(B) technical termination of a partnership

does not begin a new seven-year period for each partner with respect to built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under Reg. § 1.708-1(b)(4).

- All of the above proposed regulations generally would be effective upon finalization.

- Proposed amendments to the regulations under § 755 would provide that the transferee in a substituted basis transaction succeeds to that portion of the transferor's basis adjustment attributable to the transferred partnership interest, and that the adjustment is taken into account in determining the transferee's share of the adjusted basis to the partnership for purposes of §§ 1.743-1(b) and 1.755-1(b)(5). The proposed amendments (Prop. Reg. § 1.755-1(b)(5)) also deal with allocating § 743(b) basis adjustments resulting from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest and from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. The new rules would apply, for example, if a partnership interest is contributed to a corporation in a transaction to which § 351 applies, if a partnership interest is contributed to a partnership in a transaction to which § 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which § 731(a) applies. The proposed amendments to the § 755 regulations have varying retroactive effective dates, mostly reaching back to 12/15/99, but some retroactive to 6/9/03, and others effective 1/16/14.

## F. Partnership Audit Rules

1. **The IRS gets a second bite at this TEFRA apple even if the in-house rules were not followed.** NPR Investments, LLC v. United States, 732 F. Supp. 2d 676 (E.D. Tex. 8/10/10). NPR was a partnership formed to execute an R.J. Ruble, Sidley Austin, Son-of-Boss abusive tax shelter deal. The three partners were partners in a plaintiff's contingency fee law firm, and two of them were the taxpayers in *Klamath Strategic Investment Fund, LLC v. United States*, 568 F.3d 537 (5th Cir. 5/21/09). When the partners withdrew from NPR, they transferred the inflated basis foreign currency from NPR to their law firm partnership. On its tax return, NPR indicated that it was not a partnership subject to TEFRA audit procedures, when in fact it was a TEFRA partnership. In the initial audit of NPR's returns, the IRS applied normal partnership audit procedures and issued a final no-adjustment notice to the partnership. Rather than proposing adjustments to the NPR return, the IRS determined that it would deny loss deductions through the issuance of notices of deficiency directly to the NPR partners. In a higher-level review, the IRS determined that NPR was a TEFRA partnership and that the deficiency action required issuance of an FPAA to the NPR partners

adjusting NPR partnership items. Section 6223(f) provides that if the IRS mails a notice of final partnership administrative adjustment, it may not mail another notice in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact. The taxpayers argued that the second notice was invalid. The court (Judge Ward) found that the initial notice to NPR met the statutory criteria for an FPPA, even though it was sent through the normal audit process. The court indicated that there is nothing in statute or case law that affects the validity of an FPPA by whether the IRS followed proper internal procedures in issuing the notice. However, the court also found that the taxpayer's misrepresentation of the TEFRA audit status on NPR's partnership return by failing to check the box indicating it was subject to the TEFRA provisions was a "misrepresentation of a material fact" invoking the exception in § 6223(f) that allows a second notice.

- The court also held that the taxpayers reasonably relied on their tax advisors and declined to impose accuracy-related penalties for substantial understatement of income tax or negligence under §§ 6662(b) and 6664(c)(1). In an earlier opinion, the court had concluded that, under Fifth Circuit precedent, the 20 percent penalty for a substantial valuation misstatement and 40 percent penalty for a gross valuation misstatement provided in §§ 6662(b)(3) and 6662(h) did not apply because the taxpayers had conceded the merits of the case on grounds unrelated to basis or value of property. *NPR Investments LLC v. United States*, 105 A.F.T.R.2d 2010-1082 (2/24/10).

**a. The Fifth Circuit affirms, but concludes that valuation misstatement and substantial understatement penalties apply.** *NPR Investments, LLC v. United States*, 740 F.3d 998 (5th Cir. 1/23/14). In an opinion by Judge Owen, the Fifth Circuit affirmed without deciding that the initial notice to NPR was an FPAA and concluded that, even if it was, the District Court correctly ruled that a second FPAA was not barred by § 6223(f) because NPR made a "misrepresentation of a material fact" on its partnership return. The court reversed the District Court's ruling that valuation misstatement penalties could not apply based on the U.S. Supreme Court's decision on this issue in *United States v. Woods*, 134 S. Ct. 557, (12/3/13). Because the court concluded that there was no substantial authority for the tax treatment of the transactions, the Fifth Circuit also held, contrary to the District Court's ruling, that the accuracy-related penalty for a substantial understatement of income tax applied. The court further held that the District Court had no jurisdiction to determine in this partnership-level proceeding whether the individual partners had reasonable cause for the understatement as provided in § 6662(c)(1) and therefore vacated the District Court's ruling on this issue.

**2. Even some dim-witted law professors can understand this TEFRA case.** Greenwald v. Commissioner, 142 T.C. No. 18 (5/21/14). The taxpayers owned interests in partnerships that were subject to the TEFRA partnership audit and litigation procedures. The partnerships liquidated, and the partnership items for the year of liquidation were determined in partnership-level proceedings. Following those proceedings, the IRS asserted a deficiency with respect to the taxpayer-partners' gain on the liquidations. The taxpayers argued that outside basis is a partnership item that should have been determined at the partnership level and that the deficiency notices were invalid. The Tax Court (Judge Buch) held that gain or loss on the disposition of an interest is an affected item that requires partner-level determinations if the amount of that gain or loss could be affected by a partner-level determination in a TEFRA partnership proceeding. Accordingly, the deficiency notices were valid and the Tax Court had jurisdiction.

**3. Jail, death, and taxes go hand in hand with cemetery plots.** McElroy v. Commissioner, T.C. Memo. 2014-163 (8/12/14). The Petitioner invested in three partnerships, each lasting a single year, that acquired cemetery plots costing \$95,639, \$169,167, and \$252,373. Each partnership contributed the plots to charitable organizations and passed through claimed charitable contribution deductions for the appraised value of the plots in the amounts of \$1,864,850, \$2,936,700, and \$5,282,050, respectively. Each partnership held the plots for less than one year. Each partnership timely filed returns for its tax years, 1996, 1997, and 1998. The Petitioner claimed charitable contribution deductions on his individual 1996, 1997, and 1998 returns and a carryover loss on his individual 1999 return. The IRS mailed FPAA's to the respective partnerships on March 31, 2000, April 11, 2001, and March 29, 2002. The promoter and tax matters partner, Glenn R. Johnston, refused to agree to an extension of the statute of limitations with respect to the first partnership, indicating that he was then under criminal investigation. Johnston filed timely petitions with the Tax Court regarding the FPAA's in 2000, 2001, and 2002. In 2005, Johnston pleaded guilty to one count of conspiracy to defraud the United States. On motion by the IRS, Johnston, who was incarcerated, was replaced as the TMP by Petitioner, who served in that capacity until Petitioner filed for bankruptcy in 2012. The partnership proceeding was concluded in 2013, and Petitioner's charitable contribution deductions were substantially reduced to a portion of the partnership's basis in the cemetery plots. On March 31, 2011, the IRS mailed a notice of deficiency to Petitioner. The court (Judge Nega) rejected Petitioner's argument that the notice of deficiency was barred by the statute of limitations. The three-year limitations of § 6501(a) is suspended with respect to partnership items subject to TEFRA under § 6229(a) until one year after the decision in a partnership proceeding becomes final. Also, under § 6229(f), the

three-year statute is extended if a partner is named as a debtor in a bankruptcy proceeding, and partnership items are declared nonpartnership items as of the day a bankruptcy petition is filed. In that case, the IRS has one year from the date of the filing to assess tax attributable to the converted items. Petitioner asserted that the partnership proceedings were invalid because on the dates the FPAA's were issued, the then TMP, Johnston, was under criminal investigation, was disqualified to serve as TMP, and could not properly commence the partnership proceedings. Alternatively, Petitioner argued that the partnership proceedings terminated earlier than the decision date because the IRS knew that Johnston could not participate as TMP. The court held that a challenge to the validity of an FPAA and the conduct of the proceeding were "typically" matters to be raised in the partnership proceeding and noted that the court in those proceedings did not find the FPAA's to be invalid, nor did the court find improprieties in those proceedings. The court further indicated that filing of petitions as to the FPAA's suspended the statute of limitations regardless of the validity of the petitions under § 6229(d), requiring only that petitions be filed to suspend the statute of limitations. In addition, even if Mr. Johnston were not qualified to act as TMP, he could have filed the petitions as a notice partner. The court also rejected the argument that the partnership proceeding terminated earlier than the date of final decision, which is derived from § 7459(c). When Petitioner filed his bankruptcy petition during the pendency of the partnership proceedings, Petitioner's partnership items became nonpartnership items and the IRS had one year from the date of the filing to mail the Notice of Deficiency, which it did.

- The court rejected Petitioner's claim that he should be able to deduct his initial \$37,500 investment in the partnerships under § 165 because the Petitioner entered into the partnerships without the requisite profit motive. Increasing charitable contribution deductions is not a non-tax profit motive.

**4. Tread lightly. Missteps by the IRS and taxpayer's representative deprive the Tax Court of jurisdiction. This case demonstrates the problems created for TEFRA by abusive shelters.** Bedrosian v. Commissioner, 143 T.C. No. 4 (8/13/14). This long, convoluted opinion (Judge Buch), reviewed by the court, examines an equally convoluted procedural morass that was created by IRS examinations which issued both a Final Partnership Administrative Adjustment (FPAA) and a notice of deficiency involving the same partnership items in a Son-of-Boss partnership. At the outset, the taxpayers were advised that their 1999 return was selected for audit and, at the request of the IRS, the taxpayers executed a Form 872 extending the statute of limitations and a Form 2848 appointing representatives. No such forms were executed regarding Stone Canyon, the partnership through which the Son-of-Boss transaction was executed. The

parties agreed that the Form 872 did not extend the limitations period for assessment of tax attributable to partnership items and affected items of Stone Canyon for tax year 1999. The IRS also examined the taxpayers' 2000 return, which had a small carryover attributable to the partnership. In the 2000 case, the taxpayers executed a Form 872-1 that extended the limitations period to assess tax, including tax attributable to items of a partnership for 2000. The revenue agent contacted the taxpayers' representative and told her that the IRS would soon issue a Notice of Beginning of Administrative Proceeding (NBAP) with respect to Stone Canyon for 1999, then issued the NBAP by mailing the notice to the taxpayers, but not their representative because no power of attorney was submitted for Stone Canyon. In April 2005, the IRS mailed the FPAA to the taxpayers, Stone Canyon, and the pass-through entities designated as partners in Stone Canyon, sending the FPAA to fourteen different addresses. The FPAA included a notice indicating that the FPAA was untimely under § 6223(e) because it was issued only 61 days following the NPAB and that the taxpayer could "elect" under § 6223(e) to opt out of the partnership proceeding. Eleven days later, the IRS issued a notice of deficiency to the taxpayers assessing tax for the same partnership items that were the subject of the FPAA. The taxpayers filed a timely petition with the Tax Court contesting the 2005 notice of deficiency, and also made a payment of \$4,269,819 to the IRS. Responding to a motion by the IRS, the Tax Court held that it lacked jurisdiction to hear the taxpayers' petition because the 2005 notice of deficiency was invalid as addressing partnership items or affected items subject to TEFRA actions. *Bedrosian v. Commissioner*, T.C. Memo. 2007-375. The court suggested, however, that it retained continuing jurisdiction to consider nonpartnership items. The IRS also issued in 2006 an affected items notice of deficiency to the taxpayers. In response to the taxpayers' petition to the Tax Court, filed in response to the 2006 notice, the court held that it lacked jurisdiction to consider the deficiencies because they had been paid and assessed prior to the issuance of the 2006 notice. *Bedrosian v. Commissioner*, T.C. Memo. 2007-376. In 2007, the taxpayers filed an untimely petition in response to the FPAA. The Tax Court rejected the taxpayers' argument that the FPAA was invalid because it was sent to the wrong address and dismissed the untimely petition for lack of jurisdiction. *Stone Canyon Partners v. Commissioner*, T.C. Memo. 2007-377. These decisions collectively were affirmed by the Ninth Circuit. *Bedrosian v. Commissioner*, 358 F. App'x 868 (9th Cir. 2009). Finally, in the instant case, after granting leave to amend, the Tax Court rejected the taxpayers' motion for summary judgment and held that the court lacked jurisdiction to consider the partnership items. The taxpayers argued that the partnership items should be considered nonpartnership items under § 6223(e), and at the request of the

court, also argued that the court had jurisdiction to consider the partnership items under § 6231(g)(2).

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

Section 6231(g)(2) provides that if the IRS reasonably, but erroneously, “determines” based on a partnership return that TEFRA applies to a partnership, then the TEFRA rules are extended to the partnership, and conversely, that if the IRS reasonably, but erroneously, “determines” based on partnership returns that a partnership is not subject to TEFRA, then TEFRA does not apply to the partnership and the normal deficiency rules are applicable. The court rejected the taxpayers’ argument that the initial audit procedure of the taxpayers’ 1999 return was a determination that the partnership was not subject to TEFRA, thereby providing the Tax Court with jurisdiction to address the partnership items in the pending deficiency procedure. The court held that the requisite determination is made, not in the audit process, but only when the IRS determines to issue an FPAA. The court also held that it would not have been reasonable in any event for the IRS to conclude that the partnership was not subject to TEFRA. Although the partnership’s return for 1999 checked a box that it was not a TEFRA partnership, the court held that the fact that K-1’s filed by the partnership showed entity partners clearly established that the partnership was not entitled to the small partnership exception from TEFRA of § 6231(a)(1)(B) (less than 10 partners) because it had pass-through entity partners.

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

- In a concurring opinion, Judge Goeke agreed with the result but took offense at the majority's application of the law of the case doctrine.

- In a dissent, Judge Vasquez stated:

The opinion of the Court departs from these deeply ingrained principles by denying the Bedrosians their day in court. I believe the result reached by the opinion of the Court is not only inconsistent with the interests of justice but is also the product of an erroneous view of the governing law.

Judge Vasquez disagreed that the law of the case doctrine precluded the court from asserting jurisdiction and asserted that the significant IRS determination under § 6223(g) was the decision to proceed with an audit of the taxpayers' individual returns at the outset, misleading the taxpayers into filing a petition for review of the Notice of Deficiency, rather than pursuing review of the FPAA.

- In his concurring opinion, Judge Halpern observed that the taxpayers had been sent copies of the FPAA as notice partners and had an opportunity to file a petition in the partnership proceeding. Judge Halpern pointed out that: "Petitioners have had their opportunity for a day in court. Whether they actually received the FPAA is beside the point. All Congress required is that it be mailed to them at a proper address."

**5. The simplification of partnership audits enacted in TEFRA continues to make partnership audits ever-more complex and procedurally mysterious.** *JT USA, LP v. Commissioner*, 771 F.3d 654 (9th Cir. 11/14/14). The Ninth Circuit, in a 2-1 opinion by Judge Trott, reversed the Tax Court's holding (131 T.C. 59 (2008)) that a taxpayer holding both direct and indirect interests in a partnership may elect under § 6223(e)(3)(B) not to be bound by the results of a TEFRA partnership proceeding as to some, but not all, of those interests held during the relevant taxable year. The taxpayers had elected to opt out of the partnership proceeding with respect to their indirect interests but to leave in that proceeding their alleged remaining direct partnership interests. If the taxpayers' elections to opt out only as indirect partners were effective, the assessment of about \$10 million of deficiencies resulting from about \$36.6 million in adjustments would have been time-barred. The majority held that, unless a partner elects to have all of his or her partnership items treated as nonpartnership items, the partner cannot elect out of the TEFRA proceeding, reasoning that

[the TEFRA] provisions were enacted *inter alia* to prevent the waste of time, effort, and resources occasioned by a multiply of proceedings such as would occur if the Tax Court's construction of §6223(e) were to prevail. In a normal case the Tax Court's ruling here would permit

‘duplicative proceedings and the potential for inconsistent treatment to partners in the same partnership,’ thus hindering the purpose and policy justifications that produces TEFRA.

Furthermore, it upheld and applied Temp. Reg. § 301.6223(e)-2T(c)(1), which provides that “the election shall apply to all partnership items for the partnership taxable year to which the election relates.”

- Judge Callahan dissented. He concluded that TEFRA allows one partner to make one election and another partner to make a different election, and that a partner who has both direct and indirect interests should have the same option, particularly where, as in this case, the IRS failed to timely notify the taxpayer that a bifurcated election was ineffective.

### G. Miscellaneous

There were no significant developments regarding this topic during 2014.

## VIII. TAX SHELTERS

### A. Tax Shelter Cases and Rulings

1. **The *Castle Harbour* saga. Will it ever end? The Second Circuit twice reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion’s share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners.** *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), *rev’d*, 459 F.3d 220 (2d Cir. 8/3/06), *on remand*, 660 F. Supp. 2d 367, *as amended*, 660 F. Supp. 2d 367 (D. Conn. 10/23/09), *rev’d*, 666 F.3d 836 (2d Cir. 1/24/12), *on remand*, 8 F. Supp. 3d 142 (D. Conn. 3/28/14).

a. ***Castle Harbour I: District Court holds for the taxpayer.*** The court found that the creation of Castle Harbour, a Nevada LLC, by General Electric Capital Corp. (GECC) subsidiaries was not designed solely to avoid taxes, but to spread the risk of their investment in fully-depreciated commercial airplanes used in their leasing operations. GECC subsidiaries put the following assets into Castle Harbour: \$530 million worth of fully-depreciated aircraft subject to a \$258 million non-recourse debt; \$22 million of rents receivable; \$296 million of cash; and all the stock of another GECC subsidiary that had a value of \$0. Two tax-indifferent Dutch Banks invested \$117.5 million in Castle Harbour. Under the LLC agreement, the tax-

indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

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

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

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

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

- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership’s taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately \$62 million in income taxes, and the court found that “it appears likely that one of GECC’s principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden.” The court understood the effects of the allocations and concluded that “by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income.” Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to “re-depreciate” the assets for tax purposes. The tax-neutrals absorbed

the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation. Nevertheless, the court upheld the allocations.

The tax benefits of the . . . transaction were the result of the allocation of large amounts of book income to a tax-neutral entity, offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not – and cannot – dispute that partners may allocate their partnership’s income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And . . . the bare allocation of a large interest in income does not violate the overall tax effect rule.

- Judge Underhill concluded:

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

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

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

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

c. ***Castle Harbour III*: Judge Underhill still likes GE. On remand in *Castle Harbour*, the District Court found a valid partnership to have existed under § 704(e) because the heading does not alter the clear language of a statute. A valid family partnership is found in the absence of a family. Additionally, in his contingent penalty findings, Judge Underhill stated that his 2004 taxpayer-favorable decision *ipso facto* means that the taxpayer's reporting position was based upon substantial authority.** 660 F. Supp. 2d 367 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09). In a carefully-written<sup>6</sup> opinion, Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the *Culbertson* totality-of-the-circumstances test ("whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not

---

6. We do not all share the opinion that the opinion is "carefully-written," but Ira thinks so. Ira's college classmate, [Judge] Pierre Leval, characterized the District Court's analysis as "thorough and thoughtful."

address the § 704(e)(1) issue. He held that the Dutch banks did satisfy the requirements of that paragraph, which reads:

(e) Family partnerships.

(1) Recognition of interest created by purchase or gift. –

A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

• In so holding, he relied upon well-settled law that the title of a statute cannot limit the plain meaning of the text and that the title is of use only when it sheds light on some ambiguous word or phrase. *See also* I.R.C. § 7806(b).

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

• It has sometimes been adduced that the fact that a court of applicable jurisdiction subsequently upholds the tax treatment of a transaction should be a strong argument for the proposition that such tax treatment was based upon substantial authority. With respect to the applicability of penalties should he be reversed on appeal, Judge Underhill stated:

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

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

The government argues that *Culbertson* and Second Circuit cases like *Slifka* and *Dyer* that interpreted *Culbertson* cannot provide substantial authority for the partnership's tax position because the Second Circuit held in *Castle Harbour II* that the Dutch Banks were not partners under *Culbertson*. The government, however, has not pointed to any Second Circuit case or other authority, prior to 1997 and 1998 when the *Castle Harbour* partners took the tax positions at issue, where the parties' good faith intention or valid business purpose in forming a partnership was not sufficient to support a conclusion of partnership status for tax purposes.

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

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

Notwithstanding that they tend to favor the government's position, the governing statute and regulation leave some ambiguity as to whether the holder of partnership debt (or an interest overwhelmingly in the nature of debt) shall be recognized as a partner. Therefore, we may consult the legislative history to see whether it sheds light on their interpretation. . . . The reports of the House and the Senate accompanying the passage of § 704(e) make clear that the

provision did not intend to broaden the character of interests in partnerships that qualify for treatment as a partnership interest to include partnership debt.

The purpose of the statute was to address an altogether different question. The concern of § 704(e)(1) was whether it matters, for the determination of whether a person is a partner for tax purposes, that the person's purported partnership interest arose through an intrafamily transfer. The section was passed to reject court opinions that refused to recognize for tax purposes transfers of partnership interests because the transfers were effectuated by intrafamilial gift, as opposed to arm's length purchase. Its focus is not on the nature of the investment in a partnership, but rather on who should be recognized for tax purposes as the owner of the interest.

- The Second Circuit went on to describe the District Court as having found that the banks incurred "real risk" that might require them to restore negative capital accounts, and thus as having concluded "that the banks' interest was therefore an 'interest in the assets of the partnership' distributable to them upon liquidation." The Second Circuit then described the District Court's finding that the banks' interest qualified as a capital interest as having been "premised entirely on the significance it accorded to the possibility that the banks would be required to bear 1% of partnership losses exceeding \$7 million, or 100% of partnership losses exceeding \$541 million." But the Second Circuit disagreed, holding that there was a mere appearance of risk, rather than any real risk, which did not justify treating the banks' interest as a capital, or equity, interest, noting that it had reached the same conclusion in its earlier opinion. The Second Circuit then suggested that:

The district court was perhaps reading § 704(e)(1) to mean that the addition to a debt interest of any possibility that the holder's ultimate entitlement will vary, based on the debtor's performance, from pure reimbursement plus a previously fixed rate of return will qualify that interest as a partnership interest, no matter how economically insignificant the potential deviation and how improbable its occurrence.

The Second Circuit "disagree[d] with any such reading of the statute. No such interpretation is compelled by the plain language of § 704(e)(1). And the fact that the statute was intended to serve an altogether different purpose is confirmed by

the legislative reports.” The Second Circuit continued:

In explaining our conclusion that the banks’ interest was not a genuine equity interest, we repeatedly emphasized that, as a practical matter, the structure of the partnership agreement confined the banks’ return to the Applicable Rate regardless of the performance of Castle Harbour. . . .

The banks’ interest was therefore necessarily not a “capital interest” . . . . Because the banks’ interest was for all practical purposes a fixed obligation, requiring reimbursement of their investment at a set rate of return in all but the most unlikely of scenarios, their interest rather represented a liability of the partnership. . . . Accordingly, for the same reasons that the evidence compels the conclusion that the banks’ interest was not bona fide equity participation, it also compels the conclusion that their interest was not a capital interest within the meaning of § 704(e)(1).

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

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

• As to the negligence penalty issue, Judge Underhill noted that the 1999 Joint Committee Study of Penalty and Interest Provisions likened the “substantial authority” standard to a 40 percent chance of success on the merits, while the “reasonable basis” standard will be satisfied [and

a taxpayer cannot be found negligent] if its tax position has a 20 percent chance of success on the merits. He refused to accept the government's argument that:

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

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

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

but caution the government against making like claims in similar situations where the law is, at best, unclear.”).  
(footnote omitted)

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

**a. *Klamath* on the merits: It does not work because it lacks economic substance, but no penalties. The authorities discussed in the Holland & Hart and Olson Lemons opinions provide “substantial authority.”** Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 1/31/07). The transactions lacked economic substance because the loans would not be used to provide leverage for foreign currency transactions, but no penalties were applicable because taxpayers passed on a 1999 investment, they thought they were investing in foreign currencies, and the tax opinions they received that relied on relevant authorities set forth in the court’s earlier opinion provided “substantial authority” for the taxpayers’ treatment of their basis in their partnerships.

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

purposes of Nix and Patterson – and not on the motives of Presidio, the managing partner of the partnership.

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

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

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

**d. A small lagniappe to the taxpayers in a tax shelter.** Klamath Strategic Investment Fund, LLC v. United States, 110 A.F.T.R.2d 2012-6021 (E.D. Tex. 9/24/12). On appeal, the Fifth Circuit Court of Appeals disallowed losses generated by a BLIPS tax shelter investment which was held to lack economic substance. *Klamath Strategic Investment Fund, LLC v. United States*, 568 F.3d 537 (5th Cir. 2009). The Court of Appeals remanded the case to the District Court to determine whether partnership operational expenses of \$903,000 and fees for investment advice to the partner investors were deductible under § 212. Based on findings by the trial court, the Court of Appeals indicated that although the transaction lacked economic substance, the profit motive of the individual investors would permit

the deduction of their economic outlays if the investors effectively controlled the partnership activities so that their profit motive would be attributable to the partnership. (The managing partners were held to have lacked the necessary profit motive to support the deductions.) The District Court (Judge Gilstrap) found that the partnerships were formed to effect an investment strategy selected by the investors, the managing partners were the managing partners “only because [the investors] said so,” and the managing partners were confined to the investment strategy directed by the investors “who could shut down the whole process by withdrawing from the partnerships they had created.” The court thus held that the investors were the parties having effective control over the partnerships. The court also held that \$250,000 of investment fees paid to investment advisors who provided guidance with respect to the partnership’s foreign currency investments were deductible. The court concluded from its reading of the Court of Appeals remand that it had jurisdiction to order the refund in the partnership proceeding, notwithstanding the fact that the expenses were not paid or incurred by the partnerships.

**e. A second trip to the Fifth Circuit, which affirms. Could this possibly be the end of the saga? Klamath Strategic Investment Fund, LLC v. United States, 557 Fed. Appx. 368 (5th Cir. 3/3/14).** The government appealed the District Court’s rulings on remand, and the Fifth Circuit, in a per curiam opinion, affirmed. The court rejected the government’s argument that the District Court had erred in determining that the investors (Nix and Patterson), rather than the managing partner (Presidio), controlled the partnership, and therefore, the profit motive of Nix and Patterson should be attributed to the partnership. The court also rejected the government’s argument that the District Court lacked jurisdiction in this partnership-level proceeding to determine that Nix and Patterson were entitled to deduct the \$250,000 fee they each paid to investment advisors. The court concluded that, because the issue of the District Court’s jurisdiction had been raised and argued in the first appeal and the Court of Appeals had included the \$250,000 fee on the list of operating expenses to be addressed on remand, the District Court had jurisdiction under the law-of-the-case doctrine.

**3. A Tax Court judge sees a MidCoast deal as immune from transferee liability. Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2011-298 (12/27/11).** The Tax Court (Judge Goeke) refused to uphold transferee liability against the shareholders of a corporation who sold the stock of the corporation engaged to a midco (Fortrend, which was brought into the deal by the infamous MidCoast to provide financing) after an asset sale. He found that the shareholders knew little about the mechanics of the transaction and exercised due diligence.

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

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

**a. But the First Circuit says Judge Goeke misunderstood Massachusetts law and tells him to try a different analysis.** Frank Sawyer Trust of May 1992 v. Commissioner, 712 F.3d 597 (1st Cir. 3/29/13). The First Circuit, in an opinion by Judge Lynch, vacated and remanded the Tax Court’s decision. The Court of Appeals held that the Tax Court correctly looked to Massachusetts law to determine whether the Trust could be held liable for the corporations’ taxes and penalties, rejecting the IRS’s argument that the Tax Court should have applied the federal tax substance-over-form doctrine to determine whether the Trust should be considered a “transferee” of the four corporations’ assets. However, the Court of Appeals held that the Tax Court erred in construing Massachusetts fraudulent transfer law (which is the Uniform Fraudulent Transfer Act) to require, as a prerequisite for the Trust’s liability, either (1) that the Trust knew

of the new shareholders' scheme or (2) that the corporations transferred assets directly to the Trust. The IRS had presented evidence of fraudulent transfers from the four corporations to the midco entities, and the midco entities purchased the four corporations from the Trust. The Court of Appeals concluded that if on remand the Tax Court were to find that at the time of the purchases, the assets of these midco entities were unreasonably small in light of their liabilities and that the midco entities did not receive reasonably equivalent value in exchange for the purchase prices, then the Trust could be held liable for taxes and penalties assessed upon the four corporations regardless of whether it had any knowledge of the new shareholders' scheme.

**b. On remand, Judge Goeke imposes transferee liability but limits the transferee's liability to the excess value it received.** Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2014-59 (4/3/14). On remand from the First Circuit, the Tax Court (Judge Goeke) held that the Trust was liable as transferee of a transferee for unpaid taxes, interest and penalties of the corporations whose stock the Trust sold, but that the amount of the Trust's liability was less than the amount asserted by the IRS in its notices of liability. Under Massachusetts fraudulent transfer law (which is the Uniform Fraudulent Transfer Act), as interpreted by the First Circuit, the Trust received a fraudulent transfer from the Fortrend acquisition vehicles if two criteria were satisfied:

- (1) the corporation (i.e., Fortrend) did not receive a reasonably equivalent value in exchange for the transfer and
- (2) the corporation either (i) was engaged or was about to engage in a business or transaction for which the remaining assets were unreasonably small, or (ii) intended to incur, believed, or reasonably should have believed that it would incur, debts beyond its ability to pay as they became due.

Judge Goeke held that both criteria were satisfied. Fortrend did not receive reasonably equivalent value because it paid the Trust more than the net book value of the corporations. The corporations that Fortrend purchased possessed only cash and liabilities for taxes. Judge Goeke concluded that the amount Fortrend paid in excess of net book value was not attributable to synergy, goodwill, or going concern value and that Fortrend "did not legitimately and reasonably expect its tax avoidance strategy [to reduce the corporations' tax liabilities] to succeed." Because Fortrend had no legitimate expectation that its tax reduction strategy would work, it should have known that purchasing the corporations would cause Fortrend to incur debts beyond its ability to pay

as they became due. Accordingly, the Trust was liable for the unpaid taxes, interest, and penalties as a transferee of a transferee.

- The notices of liability issued by the IRS stated that the Trust owed over \$20 million in federal taxes. Under Massachusetts fraudulent transfer law, a good-faith transferee is entitled to a reduction in its liability to the extent of the value it provided in the exchange. Judge Goeke viewed the Trust as a good-faith transferee and limited the Trust's liability to \$13,495,070, the amount the Trust received in excess of the corporations' net book value.

**c. Taxpayer's motion for reconsideration granted: Judge Goeke reduces the taxpayer's liability as a transferee for taxes and declines to hold it liable for accuracy-related penalties. Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2014-128 (6/25/14).** The Trust moved for reconsideration of the amount of its liability for taxes and its liability for accuracy-related penalties. The Tax Court (Judge Goeke) granted the motion. Until her death, Mildred Sawyer was the Trust's sole beneficiary. For estate tax purposes, her gross estate included all of the Trust's property, including the stock of the four corporations the Trust sold to Fortrend. The estate overpaid its estate taxes because it valued the shares at the inflated sale prices that Fortrend paid for them. The Trust also overpaid income taxes on its sale of two of the corporations because it calculated its gain with reference to the inflated sales price Fortrend paid. The IRS agreed to reduce the Trust's liability as a transferee for the corporations' income tax liability by the amount of income tax the Trust overpaid on the sale of the corporations' stock. The Trust also asserted that, under the doctrine of equitable recoupment, it was entitled to reduce its transferee liability for the corporations' income tax liability by the overpayment of estate tax made by the estate of its sole beneficiary, Mildred Sawyer. Judge Goeke agreed and concluded that the taxpayer had proved that all elements necessary for equitable recoupment were satisfied. Finally, Judge Goeke held that the Trust was not liable as a transferee for the accuracy-related penalties assessed against the four corporations. Relying on *Stanko v. Commissioner*, 209 F.3d 1082 (8th Cir. 2000), Judge Goeke held that, in order for the Trust to be liable as a transferee for the accuracy-related penalties, which arose from the corporations' substantial understatement of income many months after the Trust's transfer of their stock, the IRS must prove that the transfer was made with the intent to defraud future creditors. The IRS, Judge Goeke concluded, had failed to make this showing.

**4. Uh oh, it's midco! The Second Circuit says taxpayers can't act like the three monkeys. Diebold Foundation, Inc.**

Commissioner, 736 F.3d 172 (2d Cir. 11/14/13), vacating and remanding *Salus Mundi Foundation v. Commissioner*, T.C. Memo. 2012-61. The Second Circuit, in an opinion by Judge Pooler, vacated a Tax Court decision holding that the shareholders of a corporation, and a transferee of a shareholder, who sold stock in a midco transaction were subject to § 6901 transferee liability for the corporate level taxes that were avoided. As an initial matter, the Second Circuit overruled its holding in *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1084 (2d Cir. 1991), that mixed questions of law and fact are reviewed under a clearly erroneous standard when reviewing a Tax Court decision, and held that Tax Court fact findings are reviewed for clear error, “but that mixed questions of law and fact are reviewed de novo, to the extent that the alleged error is in the misunderstanding of a legal standard.” The Tax Court had held that because there was no conveyance from the corporation to the shareholders, under the relevant state fraudulent conveyance law (New York, NYUFCA) there was no state law liability in law or equity, and thus the successor foundations were not liable as transferees. The Tax Court did not address federal law, but concluded that because there was no state law liability, it was immaterial to the outcome of the case if the shareholder was a transferee under the terms of § 6901. The Second Circuit concluded that the two prongs of § 6901 are independent and that the Tax Court did not err by only addressing the liability prong. Section 6901 liability exists only if: (1) the party is a transferee under § 6901; and (2) the party is subject to liability at law or in equity. Federal tax law controls the first prong, while the second prong is determined by the applicable state law. If there was not a “conveyance” under state law, it did not matter whether or not the selling shareholder was a “transferee” as defined by § 6901(h). But then the Second Circuit differed with the Tax Court and held that state law transferee liability *might* have existed. Under the NYUFCA, “[i]t is well established that multilateral transactions may under appropriate circumstances be ‘collapsed’ and treated as phases of a single transaction for analysis.” Under New York law, a transaction can be collapsed if the consideration received from the first transferee [is] “reconveyed by the [party owing the liability] for less than fair consideration or with an actual intent to defraud creditors,” and “the transferee in the leg of the transaction sought to be voided [has] actual or constructive knowledge of the entire scheme that renders her exchange with the debtor fraudulent.” The Second Circuit found that it was clear that the first element had been met and that the crucial issue was whether the shareholders had “actual or constructive knowledge of the entire scheme that renders [the] exchange . . . fraudulent.” In this respect the Second Circuit held that the shareholders had such constructive knowledge.

[W]e must now assess whether the Shareholders had actual or constructive knowledge of the entire scheme. The Tax Court

concluded they did not. This assessment is a mixed question of law and fact, assessing whether based upon the facts as determined by the Tax Court, the Shareholders had constructive or actual knowledge as a matter of law. Therefore, we review de novo the Tax Court's determination that the Shareholders did not have constructive knowledge, but review for clear error the factual findings that underpin the determination.

Concluding that a party had constructive knowledge does not require a showing that the party had actual knowledge of a scheme; rather, it is sufficient if, based upon the surrounding circumstances, they "should have known" about the entire scheme. *HBE Leasing*, 48 F.3d at 636 (internal quotation marks omitted). Constructive knowledge in this context also includes "inquiry knowledge"—that is, where transferees "were aware of circumstances that should have led them to inquire further into the circumstances of the transaction, but . . . failed to make such inquiry. . . .

The Tax Court did not sufficiently address the totality of the circumstances from all of the facts, which that court had already laid out itself. . . . [i]t is of great import that the Shareholders recognized the "problem" of the tax liability arising from the built-in gains on the assets . . . . The Shareholders specifically sought out parties that could help them avoid the tax liability inherent in a C Corp holding appreciated assets. . . . The parties to this transaction were extremely sophisticated actors, deploying a stable of tax attorneys from two different firms in order to limit their tax liabilities. . . . Considering their sophistication, their negotiations with multiple partners to structure the deal, their recognition of the fact that the amount of money they would ultimately receive for an asset or stock sale would be reduced based on the need to pay the C Corp tax liability, and the huge amount of money involved, among other things, it is obvious that the parties knew, or at least should have known but for active avoidance, that the entire scheme was fraudulent and would have left Double D unable to pay its tax liability. . . . To conclude that these circumstances did not constitute constructive knowledge would do away with the distinction between actual and constructive knowledge, and, at times, the Tax Court's opinion seems to directly make this mistake. The

facts in this case strongly suggest that the parties actually knew that tax liability would be illegitimately avoided, and in any event, as a matter of law, plainly demonstrate that the parties “should have known” that this was a fraudulent scheme, designed to let both buyer of the assets and seller of the stock avoid the tax liability inherent in a C Corp holding appreciated assets and leave the former shell of the corporation, now held by a Midco, without assets to satisfy that liability.

- Because the Tax Court had determined that there was no state law liability, it did not consider the other questions determinative to the case. Accordingly, the Second Circuit remanded to the Tax Court to determine whether the shareholders were transferees under § 6901 and to resolve other procedural issues.

**a. And the Ninth Circuit sees it the same way.**

Salus Mundi Foundation v. Commissioner, 114 A.F.T.R.2d 2014-6996 (9th Cir. 12/22/14), *rev’g Salus Mundi Foundation v. Commissioner*, T.C. Memo. 2012-61. In an opinion by Judge Noonan, the Ninth Circuit reversed the same Tax Court decision that was reviewed in *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 11/14/13). In the transaction at issue, the Diebold Foundation sold corporate stock in a midco transaction and made a liquidating distribution of the sale proceeds to three separate foundations organized by the Diebold children in Arizona, Connecticut, and South Carolina. The Tax Court’s decision in favor of the foundations therefore was appealable to the Ninth, Second, and Fourth Circuits. This decision addresses the government’s appeal of the Tax Court’s decision in favor of the foundation organized in Arizona, the Salus Mundi Foundation. Like the Second Circuit, the Ninth Circuit concluded that the two prongs of § 6901 are independent and that “an alleged transferee’s substantive liability is determined solely with reference to state law, without any threshold requirement that the disputed transactions be recast under federal law.” The Ninth Circuit “adopt[ed] the reasoning of [the Second Circuit’s *Diebold*] opinion and conclude[d] that the shareholders had constructive knowledge of the tax avoidance scheme and made a fraudulent conveyance under New York law.” The court concluded that the state law liability prong of § 6901 was satisfied and remanded for a determination of the Salus Mundi Foundation’s status as a transferee and whether the IRS had assessed liability within the applicable limitations period.

**5. Son-of-Boss with a midco twist fails.** Markell Co. v. Commissioner, T.C. Memo. 2014-86 (5/13/14). The Tax Court (Judge Holmes) held that a midco transaction combined with a digital option Son-of

Boss transaction failed to create a loss to offset the gains on the sale of taxpayer's assets.

**6. Another midco deal is good enough to be true for the target's shareholders.** Julia R. Swords Trust v. Commissioner, 142 T.C. No. 19 (5/29/14). In yet another midco transaction, the Tax Court (Judge Marvel) declined to impose § 6901 transferee liability on the shareholders of the target corporation. In this case, the target corporation was a family holding corporation (Davreyn) that held stock in Alcoa. To simplify the complex series of transactions, a grantor trust, the owner of which was the midco, purchased all of the Davreyn stock from the taxpayers. As described by the court:

With the benefit of hindsight, it now appears that Alrey Trust and Alrey Acquisition were established to participate in a preplanned series of interrelated transactions designed to illegitimately avoid tax on Alrey Trust's sale of Davreyn's Alcoa stock, which it had acquired as a liquidating distribution. Alrey Trust sold the Alcoa stock incident to receiving it and reported that the substantial gain on the sale was offset by an artificial loss resulting from what appears to have been a Son-of-Boss transaction by Alrey Acquisition, the grantor of Alrey Trust.

Notwithstanding this description of the shenanigans (our terminology), Judge Marvel declined "to reconfigure [the transaction] in a way that makes the assets of petitioner trusts a source of collection for tax liabilities originally imposed on Alrey Trust and Alrey Acquisition." The reasoning, however, turned entirely on the application of state law. As an initial proposition, the opinion states:

We hereinafter assume (but do not decide) that Davreyn is liable for the tax as determined in the notice of deficiency and that petitioner trusts are 'transferees' within the meaning of section 6901, and we confine our discussion to the parties' dispute on whether applicable State law and/or State equity principles hold petitioner trusts liable for Davreyn's unpaid Federal income tax.

The critical issue was whether the court would adopt the IRS's "proposed two-step analysis to decide whether a transaction should be recast under the Federal substance over form (or similar) doctrine when analyzing whether a transferee is liable under section 6901." Judge Marvel recounted that the Tax Court

approach has been “to require that State law allow such a transaction to be recast under a substance over form (or similar) doctrine before doing so.” The opinion went on to find that:

[T]he record fails to establish that an independent basis exists under applicable State law or State equity principles for holding petitioner trusts liable for Davreyn’s unpaid tax and that holding would remain the same even if we decided that Davreyn is liable for the tax as determined in the notice of deficiency.

Judge Marvel was “unpersuaded that the Supreme Court of Virginia would apply a substance over form analysis to the present setting because, as respondent asserts, petitioner trusts and/or their representatives had actual or constructive knowledge of Alrey Trust’s plan to sell the Alcoa stock and to illegitimately avoid any resulting tax liability.”

There is no credible evidence . . . that either petitioner trusts or their representatives knew about any plan on the part of the buyer to illegitimately avoid the payment of tax on the sale of Davreyn’s Alcoa stock, and the representatives’ knowledge that an unrelated buyer planned to offset any gain from a sale of the Alcoa stock with incurred or anticipated losses is insufficient to show the existence of a preconceived plan by petitioner trusts to illegitimately avoid tax.

**7. OPIS, Schmopis, taxpayers fighting denial of tax shelter losses continue to be in denial.** Reddam v. Commissioner, 755 F.3d 1051 (9th Cir. 6/13/14), *aff’g* T.C. Memo. 2012-106. In an unsurprising opinion by Judge Hurwitz, the Ninth Circuit affirmed the denial of deductions claimed to have been generated in a KPMG OPIS tax shelter on the ground that the transaction lacked economic substance. The record supported the Tax Court’s factual conclusion that the taxpayer pursued the OPIS product solely for its tax benefits. The taxpayer failed to investigate the transaction and “KPMG’s marketing materials state[d] that the OPIS transaction ‘minimizes gain, or maximizes loss,’ an anathema to a profit-seeking investor.” Furthermore, “the evidence [was] so overwhelming that no objective investor or taxpayer would enter into the OPIS transaction for its profit making potential.”

[T]he small percentage chance that [the taxpayer’s] OPIS transaction could have created a sizeable economic gain in

return for his multi-million dollar investment pales in comparison to the expectation that it would always create a tax loss of \$42,000,000 to \$50,000,000. No matter how the underlying Deutsche Bank stock performed, the OPIS transaction was designed inevitably to produce a tax loss . . .

#### **B. Identified “Tax Avoidance Transactions”**

There were no significant developments regarding this topic during 2014.

#### **C. Disclosure and Settlement**

There were no significant developments regarding this topic during 2014.

#### **D. Tax Shelter Penalties**

1. **Now let me get this straight. I followed the Code and Regs. meticulously, claimed my loss deduction, but it was disallowed because I really had no possibility of actually making money on the deal and all I was looking for was a nice tax loss, and even though I’ve got this letter from my lawyer saying the deduction is 100 percent legal, I’m still looking at a 40 percent penalty on the deficiency. But my neighbor who deducted the cost of his kid’s college education as a business expense, which every kindergartner knows you can’t do, doesn’t have to pay any penalty because he’s dumb and his dumb, but probably honest, CPA said it was OK. Say What!?** Well, we don’t have to “know it when we see it” because Congress has defined it for us. The 2010 Health Care Reconciliation Act added new Code § 7701(o), codifying the economic substance doctrine, which has been applied by the courts for several decades as a judicial interpretive doctrine to disallow tax benefits otherwise available under a literal reading of the Code and regulations.

• **Background** — Codification of the economic substance doctrine has been on the legislative agenda many times since early in the first decade of this century, or for the past ten years (for those of us still hung up on Y2K). The move for codification was motivated in part by the insistence of not a few tax practitioners that the economic substance doctrine simply was not actually a legitimate element of the tax doctrine, notwithstanding its application by the courts in many cases over several decades. This argument was based on the assertion that the Supreme Court had never actually applied the economic substance doctrine to deny a taxpayer any tax benefits, ignoring the

Supreme Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960), and instead focusing on the Supreme Court's subsequent decisions in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), and *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), in which a transaction that on the facts showed the total lack of "economic substance" was upheld. Congressional concern was intensified by the decision of the Court of Federal Claims in *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007), which questioned the continuing viability of the doctrine, stating that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." See STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," 144 (JCX-18-10 3/21/10). However, in that case, the trial court found that the particular transaction at issue in the case did not lack economic substance, and thus the trial court did not actually rule on its validity, and on appeal, the Court of Appeals for the Federal Circuit vacated the Court of Federal Claims' decision and, reiterating the validity of the economic substance doctrine and, in the opinion of some, expanding it greatly, held that transaction in question lacked economic substance. Although the economic substance doctrine has been articulated in a number of different manners by different courts over the years, its purpose is aptly described by the Court of Appeals for the Federal Circuit in *Coltec Industries v. United States*, *supra*.

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.

• The modern articulation of the doctrine traces its roots back to *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), where the Court upheld the taxpayer's treatment of an early version of a SILO, stating as follows:

[W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged

by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

• This passage—which sets forth a statement as to what was sufficient for economic substance, but which was subsequently interpreted to be a statement as to what was necessary for economic substance<sup>7</sup>—has led courts to two different formulations of the economic substance doctrine. One, the so-called “conjunctive test” requires that a transaction have *both* (1) economic substance and (2) a non-tax business purpose in order to be respected for tax purposes. *See, e.g., Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9 (2009); *Coltec, supra*. Under the other formulation, the so called “disjunctive test,” represented principally by *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001), and *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), a transaction would be respected for tax purposes if it had *either* (1) economic substance or (2) a non-tax business purpose. Yet a third articulation appeared in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999), where the court concluded that “these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.” The courts also have differed with respect to the nature of the non-tax economic benefit a taxpayer is required to establish to demonstrate that a transaction has economic substance. Some courts required a potential economic profit. *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). Other courts have applied the economic substance doctrine to disallow tax benefits where—even though the taxpayer was exposed to risk and the transaction had a profit potential—compared to the tax benefits, the economic risks and profit potential were insignificant. *Sheldon v. Commissioner*, 94 T.C. 738 (1990); *Goldstein, supra*. Yet other courts have

---

7. Ira believes that the interpretation contains an error in logic which takes a statement from the *Frank Lyon* case as to what is “sufficient” for economic substance and construes it as a statement as to what is “necessary” for economic substance. Marty does not so believe, or thinks that the alleged error is irrelevant. Bruce is too young to have an opinion because he was still in high school when *Frank Lyon* was decided.

asked whether a stated business benefit—for example, cost reduction, as opposed to profit-seeking—of a particular transaction was actually obtained through the transaction in question. See *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007). Finally, notwithstanding that several courts have rejected the bootstrap argument that an improved financial accounting result—derived from tax benefits increasing after-tax profitability—served the valid business purpose requirement, *see, e.g., American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, *aff'd*, 326 F.3d 737 (6th Cir. 2003); *Wells Fargo & Co. v. United States*, 91 Fed. Cl. 35 (2010), taxpayers continued to press such claims.

- ***The Codified Economic Substance***

***Doctrine*** — The codification of the economic substance doctrine in new § 7701(o) clarifies and standardizes some applications of the economic substance doctrine when it is applied, but does not establish any rules for determining when the doctrine should be applied. According to the legislative history, “the provision [I.R.C. § 7701(o)(5)(C)] does not change present law standards in determining when to utilize an economic substance analysis.” See STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT,” 152 (JCX-18-10 3/21/10). Thus, “the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.” *Id.* at 153. Codification of the economic substance doctrine was not intended to alter or supplant any other judicial interpretive doctrines, such as the business purpose, substance over form, and step transaction doctrines, or any similar rule in the Code, regulations, or guidance thereunder; § 7701(o) is intended merely (merely?) to supplement all the other rules. *Id.* at 155.

- ***Conjunctive analysis of objective and***

***subjective prongs*** — One of the most important aspects of new § 7701(o) is that it requires a *conjunctive* analysis under which a transaction has economic substance only if (1) the transaction changes the taxpayer’s economic position in a meaningful way apart from Federal income tax effects *and* (2) the taxpayer has a substantial business purpose, apart from Federal income tax effects, for entering into such transaction. (The second prong of most versions of the codified economic substance doctrine introduced in earlier Congresses added “and the transaction is a reasonable means of accomplishing such purpose.” *See, e.g., H.R. 2345*, 110th Cong., 1st Sess. (2007); *H.R. 2*, 108th Cong., 1st Sess. (2003). It is not clear what difference in application was intended by adoption of the different final statutory language.) This conjunctive test resolves the split between the Circuits (and between the Tax Court and certain Circuits) by rejecting the view of those courts that find the economic substance doctrine to have been satisfied

if there is either (1) a change in taxpayer's economic position or (2) a nontax business purpose, see, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *IES Industries, Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001). Section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions. The Staff of the Joint Committee Report indicates that the provision "does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine," and gives as an example the courts' ability "to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits."

• ***Claim of Profit Potential*** — Section 7701(o)(2) does not require that the taxpayer establish profit potential in order to prove that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-income-tax purpose. Nor does it specify a threshold required return if the taxpayer relies on the profit potential to try to establish economic substance. (In this respect the enacted version differs from earlier proposals that would have required the reasonably expected pre-tax profit from the transaction to exceed a risk-free rate of return. See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003).) But if the taxpayer does rely on a profit potential claim, then the profit potential requires a present value analysis:

The potential for profit of a transaction shall be taken into account in determining whether the requirements of [the § 7701(o) test for economic substance] are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

• Thus, the analysis of profit potential by the Court of Federal Claims in *Consolidated Edison Co. of New York v. United States*, 90 Fed. Cl. 228 (2009), which appears not to have thoroughly taken into account present value analysis, would not stand muster under the new provision. In all events, transaction costs must be taken into account in determining pre-tax profits, and the statute authorizes regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. Any state or local income tax effect that is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. Thus, state tax savings that piggy-back on Federal income tax savings cannot provide either a profit potential or a business purpose. Similarly, a financial accounting benefit cannot satisfy the

business purpose requirement if the financial accounting benefit originates in a reduction of Federal income tax.

- ***Don't worry, be happy! [?]*** — Section 7701(o)(5)(B) specifically provides that the statutory modifications and clarifications apply to an individual only with respect to “transactions entered into in connection with a trade or business or an activity engaged in for the production of income.” (We wonder what else anybody would have thought they might apply to? The home mortgage interest deduction? Charitable contributions of appreciated property? How about a Son-of-Boss transaction where there is no possibility for profit?) More importantly, according to STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT,” 152-153 (JCX-18-10 3/21/10), “[t]he provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.” The list of transactions and decisions intended to be immunized for the application of the economic substance doctrine includes:

(1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

- Leasing transactions will continue to be scrutinized based on all of the facts and circumstances.

- ***Jettisoned along the way*** — Many earlier versions of the codification of economic substance doctrine, some of which were adopted by the House, also provided special rules for applying what was essentially a *per se* lack of economic substance in transactions with tax indifferent parties that involved financing, and artificial income and basis shifting. *See, e.g.*, H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). These rules did not make it into the enacted version. Special statutory rules for

determining the profitability of leasing transactions also did not find their way into the final statutory enactment.

- **Penalties, oh what penalties!** — New § 6662(b)(6), in conjunction with new § 6664(c)(2), imposes a *strict liability* 20 percent penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the meaning of new § 7701(o), “or failing to meet the requirements of any similar rule of law.” (Does that extend to substance versus form in a SILO? How about business purpose in a purported tax-free reorganization?) The penalty is increased to 40 percent if the taxpayer does not adequately disclose the relevant facts on the original return, or an amended return filed before the taxpayer has been contacted for audit—an amended return filed after the initial contact cannot cure the original sin. I.R.C. § 6664(i). Because the § 6664(c) “reasonable cause” exception is unavailable, outside (or in-house) analysis and opinions of counsel or other tax advisors will not insulate a taxpayer from the penalty if a transaction is found to lack economic substance. Likewise, new § 6664(d)(2) precludes a reasonable cause defense to imposition of the § 6662A reportable transaction understatement penalty for a transaction that lacks economic substance. (Section 6662A(e)(2) has been amended to provide that the § 6662A penalty with respect to a reportable transaction understatement does not apply to a transaction that lacks economic substance if a 40 percent penalty is imposed under § 6662(i)). A similar no-fault penalty regime applies to excessive erroneous refund claims that are denied on the ground that the transaction on which the refund claim was based lacked economic substance. § 6676(c). However, under the “every dark cloud has a silver lining” maxim, the §§ 6662(b)(6) and 6664(c)(2) penalty regime does not apply to any portion of an underpayment on which the § 6663 fraud penalty is imposed.

- **Effective date** — Section 7701(o) and the revised penalty rules applied to transactions entered into after the date of enactment and to underpayments, understatements, refunds, and credits attributable to transactions entered into after 3/30/10.

a. **Better than a sharp stick in the eye, but not much better. The IRS is catching conjunctivitis, weighing in on the conjunctive test.** Notice 2010-62, 2010-40 I.R.B. 411 (9/13/10). The IRS indicates that it will rely on relevant case law in applying the two-pronged conjunctive test for economic substance. Thus, both in determining whether a transactions meets both of the requirements of the conjunctive test, the IRS will apply cases under the common law economic substance doctrine to determine whether tax benefits are allowable because a transaction satisfies the economic substance prong of the economic substance doctrine and to determine whether a transaction has a sufficient nontax purpose to satisfy the requirement that the tax benefits of a transaction are not allowable because the

taxpayer lacks a business purpose. The IRS adds that it will challenge taxpayers who seek to rely on case law that a transaction will be treated as having economic substance merely because it satisfies either of the tests. The IRS also indicated that it anticipates that the law of economic substance will continue to evolve and that it “does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.”

- The notice also indicates that, except for reportable transactions, disclosure for purposes of the additional penalty of § 6621(i) will be adequate if the taxpayer adequately discloses on a timely filed original return, or on a qualified amended return, the relevant facts affecting the tax treatment of the transaction. A disclosure that would be deemed adequate under § 6662(d)(2)(B) will be treated as adequate for purposes of § 6662(i). The disclosure should be made on a Form 8275 or 8275-R.

**b. In the absence of helpful IRS guidance, LB&I steps up with something to lean on for the meanwhile. Taxpayers must be notified at the outset of the process.** LB&I-4-0711-015. Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (7/15/11). The Large Business and International Division of the IRS has issued guidance regarding the process that an examiner must follow in determining whether to seek approval of the Director of Field Operations (DFO) to apply the § 7701(o) economic substance doctrine. “An examiner should notify a taxpayer that the examiner is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins the analysis in the steps described below.” There are three steps in the analysis.

- *Three-step analysis:* First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate. Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate. Third, if an examiner determines that the application of the doctrine may be appropriate, the examiner must make a series of inquiries before seeking approval to apply the doctrine.

- Facts and circumstances indicating that the economic substance doctrine should **not** be applied:

- (1) The transaction is not promoted/developed/administered by tax department or outside advisors;
- (2) The transaction is not highly structured;
- (3) The transaction contains no unnecessary steps;

- (4) The transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives;
- (5) The transaction is at arm's length with unrelated third parties;
- (6) The transaction creates a meaningful economic change on a present value basis (pre-tax);
- (7) The taxpayer's potential for gain or loss is not artificially limited;
- (8) The transaction does not accelerate a loss or duplicate a deduction;
- (9) The transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
- (10) The taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- (11) The transaction does not involve a tax-indifferent counter-party that recognizes substantial income;
- (12) The transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- (13) The transaction has credible business purpose apart from federal tax benefits;
- (14) The transaction has meaningful potential for profit apart from tax benefits;
- (15) The transaction has significant risk of loss;
- (16) Tax benefit is not artificially generated by the transaction;
- (17) The transaction is not pre-packaged; and
- (18) The transaction is not outside the taxpayer's ordinary business operations.

• Facts and circumstances indicating that the economic substance doctrine **should be** applied:

- (1) The transaction is promoted/developed/administered by tax department or outside advisors;
- (2) The transaction is highly structured;
- (3) The transaction includes unnecessary steps;
- (4) The transaction is not at arm's length with unrelated third parties;
- (5) The transaction creates no meaningful economic change on a present value basis (pre-tax);
- (6) The taxpayer's potential for gain or loss is artificially limited;
- (7) The transaction accelerates a loss or duplicates a deduction;
- (8) The transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);

- (9) The taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- (10) The transaction involves a tax-indifferent counter-party that recognizes substantial income;
- (11) The transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- (12) The transaction has no credible business purpose apart from federal tax benefits;
- (13) The transaction has no meaningful potential for profit apart from tax benefits;
- (14) The transaction has no significant risk of loss;
- (15) Tax benefit is artificially generated by the transaction;
- (16) The transaction is pre-packaged; and
- (17) The transaction is outside the taxpayer's ordinary business operations.

- The seven required subsequent inquiries:

(1) Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(2) Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(3) Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(4) Does the transaction involve tax credits (e.g., low income housing and alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(5) Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(6) Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a

partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(7) In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

- *Approval Process.* If an examiner completes the inquiries described above and concludes that it is appropriate to seek approval for the application of the economic substance doctrine, the examiner, in consultation with his or her manager and territory manager, should describe the analysis in writing for the appropriate Director of Field Operations, whose approval is required.

- *Penalties Limitation.* Until further guidance is issued, the penalties provided in §§ 6662(b)(6), 6662(i), and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g., step transaction doctrine, substance over form, or sham transaction).

- *Really!?* The final sentence of the directive reads as follows: "This LB&I Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such."

c. **"I'm not sure how important it is to have formal guidance — this is what's supposed to be issued. It sets forth the procedures that exam, counsel, [and] managers need to follow . . . who's the formal guidance supposed to benefit?"** *LB&I Directive Limits Strict Liability Penalties Under Economic Substance Doctrine*, 2011 TAX NOTES TODAY 137-1 (7/18/11). Deborah Butler states that taxpayers may not rely on this guidance.

d. **Can this notice be relied upon, or is this just another example of "You [fouled] up—you trusted us"?** Notice 2014-58, 2014-44 I.R.B. 746 (10/9/14), *amplifying* Notice 2010-62, 2010-40 I.R.B. 411 (9/13/10). This notice provides that the term "transaction" generally includes all the factual elements relevant to the expected tax treatment of any plan, with facts and circumstances determining whether a plan's steps are

aggregated or disaggregated. The term “similar rule of law” (as described in the § 6662(b)(6) penalty provision) means a rule or doctrine that disallows the tax benefits related to a transaction by applying the same factors and analysis that is required under § 7701(o) for an economic substance analysis even if a different term (e.g., “sham transaction doctrine”) is used to describe the rule or doctrine.

- Finally, the notice provides that the IRS will not apply a penalty under § 6662(b)(6) or otherwise argue that a transaction is not described in that paragraph, unless it also raises § 7701(o) to support the underlying adjustments.

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

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

- Although the ABA lost in the Supreme Court, *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (holding that the American Bar Endowment’s income from life insurance policy dividends retained represent profits from the insurance program rather than charitable

donations from its members, but that if the members were given a choice between allowing the American Bar Endowment to retain the dividends and having the dividends refunded to them, then the dividends retained might constitute charitable donations rather than unrelated business income), it changed its insurance arrangements to achieve the same result by permitting cash refunds to policyholders who claimed them in writing each year, P.L.R. 8725056 (3/25/87).

**a. The Seventh Circuit follows the Reg. § 1.501(c)(6)-1 definition of § 501(c)(6) “business league” in finding that the ABA retirement program was not one.** ABA Retirement Funds v. United States, 759 F.3d 718 (7th Cir. 7/21/14). Specifically, the Seventh Circuit (Judge Wood) affirmed on the grounds that the non-profit ABA Retirement Funds: (1) did not improve business conditions of the legal profession but instead provided retirement plans to individual lawyers; and (2) engaged in a business ordinarily conducted for profit.

- Note that § 501(c)(6) specifically provides that professional football leagues are tax-exempt business leagues, “whether or not administering a pension fund for football players.”

**2. Help(?) for those who missed filing required annual returns or notices for three consecutive years, and also missed the reinstatement procedures previously available.** Rev. Proc. 2014-11, 2014-3 I.R.B. 411 (1/2/14). This revenue procedure provides procedures for reinstating the tax-exempt status of organizations that have had their tax-exempt status automatically revoked under § 6033(j) for failure to file required annual returns or notices for three consecutive years. Generally, to obtain retroactive reinstatement of the organization’s tax-exempt status, it must apply not later than 15 months after the later of (1) the date of the revocation letter or (2) the date on which the IRS posted the organization’s name on the Revocation List. A streamlined process is available for an organization that was eligible to file either Form 990-EZ or 990-N for each of the three consecutive years that it failed to file, and that has not previously had its tax-exempt status automatically revoked pursuant to § 6033(j). Additional conditions apply if an organization seeks retroactive reinstatement of the organization’s tax-exempt status, and if it applies more than 15 months after the later of (1) the date of the revocation letter or (2) the date on which the IRS posted the organization’s name on the Revocation List.

**3. The IRS continues to have problems with exempt organization issues.** Z Street, Inc. v. Koskinen, 113 A.F.T.R.2d 2014-2217 (D.D.C. 5/27/14). The District Court (Judge Jackson) refused to dismiss a complaint filed by a pro-Israel nonprofit group seeking declaratory and

injunctive relief with respect to the processing of its application for § 501(c)(3) status. The complaint asserted that the IRS had a special policy of intense scrutiny, which it applied to organizations whose activities relate to Israel “and whose positions with respect to Israel contradict the current position of the U.S. Government.” The court refused to dismiss this constitutional claim based on the premise that the Israel Special Policy constituted “impermissible viewpoint discrimination on the part of the federal government.” Judge Jackson rejected the government’s assertions that the action should be dismissed under (1) the Anti-Injunction Act, 26 U.S.C. § 7421; (2) the Declaratory Judgment Act, 28 U.S.C. § 2201; and (3) the doctrine of sovereign immunity.

**4. The IRS introduces Form 1023-EZ, a shorter application form to help small charities apply more easily for recognition of tax-exempt status under § 501(c)(3).** T.D. 9764, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 79 F.R. 37630 (7/2/14). The Treasury has issued proposed and temporary regulations that permit the IRS to adopt a streamlined application process that eligible organizations may use to apply for recognition of tax-exempt status under § 501(c)(3). The temporary regulations, § 1.508-1T(a)(2)(i), provide that eligible organizations may use Form 1023-EZ, “Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,” to notify the IRS of their applications for tax-exempt status. The regulations were effective on 7/1/14.

- According to an announcement issued by the IRS, “[t]he change will allow the IRS to speed the approval process for smaller groups and free up resources to review applications from larger, more complex organizations while reducing the application backlog. Currently, the IRS has more than 60,000 501(c)(3) applications in its backlog, with many of them pending for nine months.” *New 1023-EZ Form Makes Applying for 501(c)(3) Tax-Exempt Status Easier; Most Charities Qualify*, 2014 TAX NOTES TODAY 127-13 (7/1/14).

**a. The IRS provides guidance on the new streamlined application process for recognition of tax-exempt status under § 501(c)(3).** Rev. Proc. 2014-40, 2014-30 I.R.B. 229 (7/1/14). This revenue procedure sets forth the procedures for applying for recognition of (and for issuing determination letters on) an organization’s tax-exempt status under § 501(c)(3) using Form 1023-EZ. Generally, an organization can submit Form 1023-EZ (rather than Form 1023) if it is a U.S. organization with both assets valued at \$250,000 or less and annual gross receipts of \$50,000 or less. The revenue procedure sets forth a lengthy list of organizations that cannot submit Form 1023-EZ, including churches, schools, colleges, and hospitals.

Form 1023-EZ must be submitted electronically and the user fee for doing so is \$400, as opposed to the \$850 user fee charged to organizations submitting Form 1023 that have actual or anticipated average annual gross receipts exceeding \$10,000. Organizations that submit Form 1023-EZ need not separately request a determination that they need not file an annual return on Form 990 or Form 990-EZ if they claim a filing exemption solely on the basis that their gross receipts are normally \$50,000 or less. The revenue procedure was effective 7/1/14.

**5. An unsuccessful attempt to expedite discovery to help uncover what happened to Lois Lerner's missing emails.** True the Vote, Inc. v. IRS, 114 A.F.T.R.2d 2014-5663 (D.D.C. 8/7/14). Judge Walton sided with the IRS in a conservative group's lawsuit by denying the group's requests to (1) grant a preliminary injunction to require the IRS to preserve Lois Lerner's emails and (2) allow expedited discovery by an independent expert to search for those of her emails that were missing. He further found no obligation to preserve the emails relevant to this case by reason of the filing of *Z Street, Inc. v. Koskinen*, 113 A.F.T.R.2d 2014-2217 (D.D.C. 5/27/14), in December 2010 because the cases were "grounded on factually different subjects."

**6. Final regulations on the § 501(r) requirements for charitable hospitals.** T.D. 9708, Additional Requirements for Charitable Hospitals; Community Health Needs Assessments for Charitable Hospitals; Requirement of a Section 4959 Excise Tax Return and Time for Filing the Return, 79 F.R. 78954 (12/31/14). Section 501(r), enacted as part of the Patient Protection and Affordable Care Act of 2010, adds requirements for hospital organizations to be recognized as exempt under § 501(c)(3). The Treasury Department has finalized regulations proposed under § 501(r) in REG-130266-11, Additional Requirements for Charitable Hospitals, 77 F.R. 38148 (7/26/12), and REG-106499-12, Community Health Needs Assessments for Charitable Hospitals, 78 F.R. 20523 (4/5/13). The final regulations provide detailed guidance to charitable hospital organizations on the requirements imposed by § 501(r) and related excise tax and reporting obligations.

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

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

- make reasonable efforts to determine whether an individual is eligible for assistance under the hospital's financial assistance policy before engaging in extraordinary collection actions against the individual; and
- conduct a community health needs assessment (CHNA) and adopt an implementation strategy at least once every three years.

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

- The Treasury Decision also provides guidance—initially proposed in the 2013 proposed regulations—related to (1) the \$50,000 excise tax imposed by § 4959 on a hospital organization that fails to meet the CHNA requirements, and (2) the requirement imposed by § 6033(b)(15) that a hospital organization attach to its Form 990 both audited financial statements and a description of the actions taken during the taxable year to address the significant health needs identified through its most recently conducted CHNA.

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

## B. Charitable Giving

1. **No Mardi Gras beads from the Tax Court for this taxpayer.** *Whitehouse Hotel Limited Partnership v. Commissioner*, 131 T.C. 112 (10/30/08). The Tax Court (Judge Halpern) held that, as a precondition to using the replacement cost approach to valuing real estate, the taxpayer must show that the property is unusual in nature and other methods of valuation, such as comparable sales or income capitalization, are not applicable. The income approach to valuation is favored only where comparable market sales are absent. On the facts, the \$7,445,000 claimed value of the contribution of a conservation facade easement for an historic structure on the edge of the French Quarter in New Orleans overstated the value determined by Judge Halpern (\$1,792,301) by \$5,652,699. The accuracy-related penalty for gross overvaluation was proper because the claimed value was greater than 400 percent of the value determined, and the taxpayer was not relieved of the

penalty based upon reasonable cause because there was no good faith investigation into the value of the easement.

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

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

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

**b. Judge Halpern reconsidered the whole case in light of the Fifth Circuit decision and increased the allowable deduction by only \$65,415, from \$1,792,301 to \$1,857,716.** Whitehouse Hotel Limited Partnership v. Commissioner, 139 T.C. 304 (10/23/12). On remand, Judge Halpern elaborated at length on the proper valuation method to be used to value the building under the “before and after” method, and once again accepted the IRS’s argument that the value of the property should be determined using a comparable-sales method. The comparable-sales method applied by Judge Halpern was based on the sales of buildings suitable for conversion into hotels based primarily on local sales data, rejecting the

taxpayer's argument that non-local sales data should be taken into account. He again rejected both the taxpayer's reproduction-cost method and income method to valuation. Judge Halpern explained that "[t]he reproduction cost of an historic building usually bears little relationship to its present economic value. Such cost is usually far in excess of the cost of construction of a similarly sized modern structure, and may reflect the price of materials and workmanship that are no longer readily available." Because reconstruction of the Maison Blanche Building, if destroyed, would not have been a reasonable business venture, there was no probative correlation between the taxpayer's expert's estimate of the reproduction cost of the Maison Blanche Building and the fair market value of the property. Judge Halpern rejected the income valuation method because in this case, where there was no ongoing business, it was based on too many contingencies, was inadequately developed, and thus was too speculative, particularly where the value could be established by comparable sales. He did not reject the income method of valuation as a matter of law. He stated: "We have no difficulty with the process. Where we have difficulty is with petitioner's call to trust on their face [the taxpayer's expert's] judgments as to values to be input to his model." Judge Halpern also again found that the easement conveyance did not deprive the partnership or any subsequent owner of the ability to add stories to the top of the Kress Building or blocking views of the Maison Blanche facade. However, in light of the Fifth Circuit's directive, Judge Halpern determined the value of the facade conservation easement based on the before- and after-restriction values of the combined Maison Blanche and Kress Building property. He concluded that the value of the easement was approximately \$1.86 million, rather than \$1.79 million as determined in his first opinion. Responding to the Fifth Circuit's determination that he had misapprehended the properties' highest and best use, Judge Halpern reasoned that:

although the highest and best use of property may determine a ceiling on how much a willing buyer would pay for the property, it does not necessarily determine a floor on how little a willing seller would accept. . . . [T]he hypothetical willing buyer and the hypothetical willing seller who populate our standard definition of fair market value will not invariably conclude their negotiation over price at a price reflecting the value of the property at its highest and best use.

He turned to auction price theory to conclude that in determining the fair market value of the property, which is the relevant benchmark:

[T]he equilibrium price at which the willing buyer and the willing seller would meet would be somewhere between the

value of the property taking into account its most productive use (i.e., its highest and best use) and the value of the property taking into account its second most profitable use.

Accordingly, he rejected the taxpayer's argument that the valuation should be based on the use of the buildings as the shell of a luxury hotel, there being no scarcity of buildings in New Orleans suitable for development as luxury hotels. "Only if there were sufficient scarcity would the partnership . . . capture a piece of the economic return to luxury hotel development of the building's shell." Finally, based on the \$1.86 million value, the claimed value of the easement exceeded 400 percent of the actual value (i.e., 401 percent) and the § 6662(h) gross valuation misstatement penalty applied. The § 6664(c) reasonable cause and good-faith exceptions did not apply, because Whitehouse failed to make a good-faith investigation of the value of the easement and did not reasonably rely on an appraisal.

**c. In its second consideration, the Fifth Circuit affirmed Judge Halpern on the amount of the deduction but vacated the 40 percent gross overstatement penalty.** *Whitehouse Hotel Limited Partnership v. Commissioner*, 755 F.3d 236 (5th Cir. 6/11/14), *aff'g in part and vacating in part*, 615 F.3d 321 (5th Cir. 8/10/10). The Fifth Circuit (Judge Southwick) agreed with Judge Halpern's determination of the amount of the deduction on remand despite his near-insubordination to the earlier Fifth Circuit opinion by saying, "Begrudging compliance with our mandate is nevertheless compliance." However, Judge Southwick's opinion vacated the gross valuation misstatement penalty because the taxpayer's good faith defense was valid, stating:

We are particularly persuaded by Whitehouse's argument that the Commissioner, the Commissioner's expert, and the tax court all reached different conclusions. The Commissioner originally permitted only \$1.15 million as a deduction. [The Commissioner's expert] valued the easement as worthless. We share the tax court's and the Commissioner's skepticism of the dramatic appreciation of value between the roughly \$8,000,000 purchase price of the Maison Blanche shell and the [taxpayer's expert's] appraisal's \$96,000,000 valuation. What the taxpayer reasonably considered, though, even if not sustained by the tax court, is that its contract to transform the building into a Ritz-Carlton hotel had value. As we were in our 2010 opinion, we are skeptical of the tax court's conclusion that following the advice of accountants and tax

professionals was insufficient to meet the requirements of the good faith defense, especially in regard to such a complex task that involves so many uncertainties. . . . for the general reasonable cause exception, we review the “totality of the facts and circumstances.” Whitehouse obtained a second appraisal as a “check” against the first one. [A Whitehouse partner] testified and presented the 1997 Form 1065 indicating it had been prepared by Whitehouse’s financial auditors. Obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally-prepared tax return is sufficient to show a good faith investigation as required by law. *See* I.R.C. § 6664(c)(3)(B). The tax court’s enforcement of the gross undervaluation penalty was clearly erroneous.  
(citations omitted)

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

**a. Plea for a mulligan is rejected!** Kaufman v. Commissioner, 136 T.C. 294 (4/4/11). On the taxpayers’ motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a “‘prior claim’ to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation,” and the agreement also provided that “the bank was entitled to those proceeds ‘in preference’ to [the donee organization] until the mortgage was satisfied and discharged.” The court also disallowed a deduction in 2003, but allowed the deduction in 2004, for a cash contribution to the donee of the conservation easement in 2003 because the amount of the cash payment was subject to refund if the appraised value of the easement was zero, and the appraisal was not determined until 2004. The court also rejected (1) the IRS’s

argument that the taxpayers received a *quid pro quo* for the cash contribution in the form of the donee organization accepting and processing their application, (2) providing them with a form preservation restriction agreement, (3) undertaking to obtain approvals from the necessary government authorities, (4) securing the lender agreement from the bank, (5) giving the taxpayers basic tax advice, and (6) providing them with a list of approved appraisers. The facts in evidence did not demonstrate a *quid pro quo*, because, among other things, many of the tasks had been undertaken by the organization before the check was received.

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

**b. The taxpayer wins the battle in the Court of Appeals with an excellent discussion of charitable contributions of easements on mortgaged property, but still might lose the war.** Kaufman v. Shulman, 687 F.3d 21 (1st Cir. 7/19/12). The First Circuit, however, in an opinion by Judge Boudin, disagreed with the Tax Court, holding that a mortgagee's right to satisfy the mortgage lien before the donee of the conservation easement is entitled to any amount from the sales or condemnation proceeds from the property does not necessarily defeat the charitable contribution deduction. Judge Boudin's opinion noted that "the Kaufmans had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds—tax liens being superior to most prior claims, 1 Powell on Real Property § 10B.06[6] (Michael Allan Wolf ed., Matthew Bender & Co. 2012), including in Massachusetts the claims of the mortgage holder."<sup>8</sup> The opinion continued by observing that:

[G]iven the ubiquity of super-priority for tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress. We normally defer to an

---

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

agency's reasonable reading of its own regulations, e.g., *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001), but cannot find reasonable an impromptu reading that is not compelled and would defeat the purpose of the statute, as we think is the case here.

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

- The First Circuit went on to reject the IRS's argument that the contribution also failed to qualify for a charitable contribution deduction because a provision in the agreement between the Kaufmans and the donee trust stated that "nothing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," citing *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011), which reasoned that such clauses permitting consent and abandonment "have no discrete effect upon the perpetuity of the easements: Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril." (quoting 646 F.3d at 10).

- The court also rejected various scattershot IRS arguments that the substantiation rules had not been met.

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

When the Kaufmans donated the easement, their home was already subject to South End Landmark District rules that severely restrict the alterations that property owners can make to the exteriors of historic buildings in the neighborhood. These rules provide that "[a]ll proposed changes or alterations" to "all elements of [the] facade, . . . the front yard . . . and the portions of roofs that are visible from public streets" will be "subject to review" by the local landmark district commission.

Under the *Standards and Criteria*, property owners of South End buildings have an obligation to retain and repair the original steps, stairs, railings, balustrades, balconies, entryways, transoms, sidelights, exterior walls, windows,

roofs, and front-yard fences (along with certain “other features”); and, when the damaged elements are beyond repair, property owners may only replace them with elements that look like the originals. Given these pre-existing legal obligations the Tax Court might well find on remand that the Kaufmans’ easement was worth little or nothing.

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

**c. Despite winning a skirmish in the First Circuit, the taxpayers ultimately lose the battle in the Tax Court—will the taxpayer try to fight another battle in the First Circuit?** Kaufman v. Commissioner, T.C. Memo. 2014-52 (3/31/14). On remand, after evaluating all of the evidence, including multiple appraisers’ reports, Judge Halpern held that the facade easement had no fair market value. The deduction for the contribution of the facade easement was disallowed. Because there was no record of sales of comparable easements, the before-and-after valuation method of Reg. § 170A-14(h)(3)(i) was applicable. He found that “the typical buyer would find the restrictions of the preservation agreement no more burdensome than the underlying South End Standards and Criteria [and] . . . the postcontribution value of the property was equal to its precontribution value . . . .” Negligence and substantial understatement accuracy related penalties were sustained. The mere fact that the taxpayers obtained an appraisal valuing the facade easement at \$220,800 did not in and of itself constitute a reasonable basis for claiming that the facade easement was worth \$220,800 when its value was in fact “nil.” The taxpayers failed to show a reasonable basis for claiming the deduction.

**3. This throws buckets and buckets of ice water on claims for charitable contribution deductions for façade easements in historic districts.** Scheidelman v. Commissioner, 755 F.3d 148 (2d Cir. 6/18/14), *aff’g* T.C. Memo. 2013-18. In a per curiam opinion by Judge Newman, the Second Circuit affirmed the Tax Court’s decision denying the taxpayer’s claimed deduction for contribution of an historic facade conservation easement to the National Architectural Trust on the ground that the contribution did not result in any diminution in the value of the property. The burdened property was in the Fort Greene Historic District, which is designated (1) a “registered historic district” by the Secretary of the Interior through the National Park Service, pursuant to § 47(c)(3)(B); and (2) an

historic district by New York City's Landmarks Preservation Commission (LPC). In New York City, it is unlawful to alter, reconstruct, or demolish a building in a historic district without the prior consent of the LPC. The Court noted:

[N]either the Tax Court nor any Circuit Court of Appeals has held that the grant of a conservation easement effects a per se reduction in the fair market value. To the contrary, the regulations provide that an easement that has no material effect on the obligations of the property owner or the uses to which the property may be put "may have no material effect on the value of the property." Treas. Reg. § 1.170A-14(h)(3)(ii). And sometimes an easement "may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable."

- Substantial evidence supports the Tax Court's conclusion that the easement had no value for charitable contribution purposes

**4. Mining is not the highest and best use for land that no one actually wants to mine.** *Esgar Corp. v. Commissioner*, T.C. Memo. 2012-35 (2/6/12). The taxpayers granted conservation easements in certain land that was zoned irrigated and agricultural, and which had historically been used as irrigated and unirrigated farmland. The land was not permitted for any mining, but absent the donations it was likely that the necessary permits to mine (gravel) could have been obtained. The terms of the conservation easements provided the donee organization with perpetual rights to preserve the natural and open space conditions and protect the wildlife, ecological, and environmental values and water quality characteristics of the property. The conservation easements specifically prohibited the mining or extraction of sand, gravel, rock, or any other mineral. The taxpayers valued the easement donation under the "before and after method," treating the highest and best use before the donation as gravel mining. The Tax Court (Judge Wherry) held that the before highest and best use was agricultural, not mining.

Where . . . an asserted highest and best use differs from current use, the use must be reasonably probable and have real market value. . . . "Any suggested use higher than current use requires both 'closeness in time' and 'reasonable probability'". *Hilborn v. Commissioner*, [85 T.C. 677, 689 (1985)]. Any proposed uses that "depend upon events or

combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable” are to be excluded from consideration. *Olson v. United States*, 292 U.S. 246, 257 (1934).

Where the asserted highest and best use of property is the extraction of minerals, the presence of the mineral in a commercially exploitable amount and the existence of a market “that would justify its extraction in the reasonably foreseeable future” must be shown. *United States v. 69.1 Acres of Land*, [942 F.2d 290, 292 (4th Cir. 1991)]. “There must be some objective support for the future demand, including volume and duration. Mere physical adaptability to a use does not establish a market.” *United States v. Whitehurst*, 337 F.2d 765, 771–772 (4th Cir. 1964); *see also United States v. 494.10 Acres of Land*, 592 F.2d 1130, 1132 (10th Cir. 1979).

Based on detailed examination of the facts and expert witness reports, the evidence did not prove that a hypothetical willing buyer in the year of the donation would have considered the land as the site for construction of a gravel mine. “While it would have been physically possible to mine the properties in 2004 (or in the future), there was no unfilled demand and there was no unmet market.” Instead, Judge Wherry found that there were comparable sales upon which a before valuation of the contribution could be based. However, Judge Wherry declined to uphold the § 6662(b)(3) substantial valuation penalty asserted by the IRS because he found that the taxpayers relied in good faith on the appraisers and the accounting firm they hired as advisors.

**a. Ditto says the Tenth Circuit.** *Esgar Corp. v. Commissioner*, 744 F.3d 648 (10th Cir. 3/7/14). In an opinion by Judge Kelly, the Tenth Circuit affirmed the Tax Court’s decision. The Court of Appeals held that the Tax Court applied the correct highest and best use standard, looking for the use that was most reasonably probable in the reasonably near future, and it did not clearly err by concluding that use was agriculture.

**5. The old adage “better late than never” didn’t save the taxpayer’s deduction for a conservation easement on mortgaged property.** *Mitchell v. Commissioner*, 138 T.C. 324 (4/3/12). In 2003, the taxpayer contributed a conservation easement on over 180 acres of unimproved land to a qualified organization. The property was subject to a mortgage, but the mortgagee did not subordinate the mortgage to the

conservation easement deed until 2005. The taxpayer claimed a charitable contribution deduction on her 2003 Federal income tax return, which the IRS disallowed. The taxpayer argued that she had met the requirement of Reg. § 1.170A-14(g)(2) requiring subordination of a mortgage to the conservation easement because Reg. § 1.170A-14(g)(3) should apply to determine whether the requirements of Reg. § 1.170A-14(g)(2) had been satisfied. Reg. § 1.170A-14(g)(3) provides that a deduction will not be disallowed merely because on the date of the gift there is the possibility that the interest will be defeated, so long as on that date the possibility of defeat is so remote as to be negligible. The taxpayer argued that the probability of her defaulting on the mortgage was so remote as to be negligible, and that the possibility should be disregarded under the so-remote-as-to-be-negligible standard in determining whether the conservation easement was enforceable in perpetuity. The Tax Court (Judge Haines) held that the so-remote-as-to-be-negligible standard of Reg. § 1.170A-14(g)(3) did not apply to determine whether the requirements of Reg. § 1.170A-14(g)(2), requiring subordination of a mortgage to the conservation easement, had been satisfied, citing *Kaufman v. Commissioner*, 136 T.C. 294 (2011), *Kaufman v. Commissioner*, 134 T.C. 182 (2010), *Carpenter v. Commissioner*, T.C. Memo. 2012-1, and distinguishing *Simmons v. Commissioner*, T.C. Memo. 2009-208, *aff'd*, 646 F.3d 6 (D.C. Cir. 2011). Thus, the taxpayer did not meet the requirements of Reg. § 1.170A-14(g)(2), and the deduction was denied. However, the taxpayer was not liable for a § 6662 accuracy related penalty. She “attempted to comply with the requirements for making a charitable contribution of a conservation easement,” she hired an accountant and an appraiser, but she “inadvertently failed to obtain[] a subordination agreement,” and “upon being made aware of the need for a subordination agreement she promptly obtained one.” She acted with reasonable cause and in good faith.

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

**b. And the subsequent First Circuit decision in *Kaufman* doesn't change the result.** *Mitchell v. Commissioner*, T.C. Memo. 2013-204 (8/29/13). In a supplemental memorandum opinion, the Tax Court (Judge Haines) denied the taxpayer's motion for reconsideration. The

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

c. **The mortgage subordination provision is “a bright line requirement.” “The remote future provision cannot be reasonably read as modifying the strict mortgage subordination requirement.”** *Mitchell v. Commissioner*, 115 A.F.T.R.2d 2015-346 (10th Cir. 1/6/15). In an opinion by Judge McHugh, the Tenth Circuit affirmed the Tax Court's decision. First, the court held that Reg. § 1.170A-14(g), requiring subordination of any mortgage as a condition of eligibility for a deduction, was valid. Second, it held that the taxpayer's arguments that she was entitled to the deduction because (1) Reg. § 1.170A-14(g) does not impose an explicit time-frame for compliance, and (2) despite the failure to subordinate the mortgage at the time of conveyance, the deed contained sufficient safeguards to protect the conservation purpose in perpetuity, both were contrary to the “plain language” of Reg. § 1.170A-14(g). Finally, the court held that the IRS “is entitled to demand strict compliance with the mortgage subordination provision, irrespective of the likelihood of foreclosure.” The court rejected the taxpayer's argument that Reg. § 1.170A-14(g)(3), which provides that a deduction will not be disallowed “merely” because the interest that passes to the donee organization may be defeated by the happening of some future event “if on the date of the gift it appears that the possibility that such . . . event will occur is so remote as to be negligible,” acts as an exception to the mortgage subordination provision. Finally, citing *Chase Bank USA, N.A. v. McCoy*, 562 U.S. 195 (2011), the court reasoned as follows.

[E]ven if the regulations were unclear with respect to the interplay between these provisions, Ms. Mitchell would not prevail. We are required to defer to the Commissioner's interpretation to resolve any ambiguity on this point unless it

is “plainly erroneous or inconsistent with the regulations” or there is any other “reason to suspect the interpretation does not reflect the agency’s fair and considered judgment on the matter.” . . . [R]ather than being plainly erroneous or inconsistent with the regulations, the Commissioner’s interpretation—that the mortgage subordination is unmodified by the remote future event provision—is consistent with the regulation’s plain meaning.

**6. The North Dakota legislature helps out North Dakotans by passing a law that prevents any conservation easement from ever qualifying for a charitable deduction.** Wachter v. Commissioner, 142 T.C. No. 7 (3/11/14). The taxpayers were the members of an LLC taxed as a partnership and partners in a partnership that sold to the North Dakota Natural Resource Trust at a bargain price conservation easements on agricultural land and claimed charitable contribution deductions for the bargain element. The IRS disallowed the deductions on the ground that a unique North Dakota state law (N.D. Cent. Code sec. 47-05-02.1 (1999 & Supp. 2013)) restricted easements to a duration of not more than 99 years, thus preventing the conservation easements from being qualified real property interests and from being exclusively for conservation purposes, as required by § 170(h). The opinion quoted the statutory language: “The duration of the easement \* \* \* on the use of real property must be specifically set out, and in no case may the duration of any interest in real property regulated by this section exceed ninety-nine years;” but it did not reveal whether the conveyance specifically stated that it was limited to 99 years. However, the taxpayers conceded that “the easements at issue will expire 99 years after they were conveyed.” Based on these facts, the Tax Court (Judge Buch) granted summary judgment for the IRS on the ground that “the State law restriction prevents the easements from being granted in perpetuity, which in turn prevents them from being both qualified real property interests under section 170(h)(2) and contributions exclusively for conservation purposes under section 170(h)(5).” Judge Buch rejected the taxpayers’ argument that “the 99-year limitation should be considered the equivalent of a remote future event or the retention of a negligible interest because at present the remainder is ‘essentially valueless.’” They argued that the possibility that the land would revert back to them or their successors in interest was the equivalent of a remote future event that pursuant to Reg. § 1.170A-14(g)(3) will not prevent the easements from being perpetual. Based on *885 Inv. Co. v. Commissioner*, 95 T.C. 156, 161 (1990), in which the Tax Court construed “‘so remote as to be negligible’ as ‘a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction,’” and other similar precedents, Judge Buch concluded that the

possibility that the donee would be divested of the conservation easements reversion not only was “not remote,” but was inevitable.

**7. What does retroactive mean? Chandler v. Commissioner, 142 T.C. No. 16 (5/14/14).** The taxpayers donated conservation easements on two residences in Boston’s South End historic district to the National Architectural Trust and claimed charitable contribution deductions of \$191,400 and \$371,250. Because of relevant limitations, the values of the easements were deducted in varying amounts from 2004 through 2006. The Tax Court (Judge Goeke) disallowed the deduction even though the conservation easements were more restrictive than local law with respect to architectural changes. Applying the reasoning of *Kaufman v. Commissioner*, T.C. Memo. 2014-52, which held that an NAT easement on a property in the South End Historic District did not reduce the value of a residence, the court disallowed the deduction entirely. The differences between the NAT restrictions and local law “do not affect property values, because buyers do not perceive any difference between the competing sets of restrictions.” Under § 6662(h), the valuation misstatements were gross valuation misstatements triggering a 40 percent penalty. However, a novel issue regarding the taxpayers’ right to raise a reasonable cause defense for their 2006 underpayment was presented because a portion of the 2006 underpayment resulted from the carryover of charitable contribution deductions they first claimed on their 2004 return, which was filed before the Pension Protection Act of 2006 eliminated the § 6664(c) good faith and reasonable cause defense for gross valuation misstatements of charitable contribution property (unless certain conditions, which were not met in this case, were met). The court rejected the taxpayer’s argument that denying their right to raise a reasonable cause defense with respect to the 2006 understatement attributable to deductions carried forward from 2004 would amount to retroactively applying the Pension Protection Act of 2006 amendment to § 6664(c). “When taxpayers file a return that includes carryforward information, they essentially reaffirm that information. The amended reasonable cause rules were in effect when petitioners filed their 2006 return, which reaffirmed the Claremont easement’s grossly misstated value. Applying those rules does not amount to retroactive application.” Ironically, however, with respect to the 2004 and 2005 deductions, the taxpayers did establish a reasonable cause defense. They had “followed the NPS’s suggestion for choosing an appraiser and relied on his report. The report was not so deficient on its face that petitioners should have reasonably discounted it. They obtained their accountant’s assurances before they claimed the easement deductions.”

**a. Ditto!** Reisner v. Commissioner, T.C. Memo. 2014-230 (11/6/14). The Tax Court (Judge Gale) followed *Chandler* regarding the elimination (by § 6664(c)(3)) of the “reasonable cause” exception to a 40 percent gross valuation misstatement penalty (§ 6662(h)(1)) for a claimed carried-over charitable contribution deduction to 2006 with respect to a contribution of a valueless facade easement in 2004. According to Reg. § 1.6662-5(c):

[T]he gross valuation misstatement penalty applies to any portion of an underpayment for a year to which a deduction is carried that is attributable to a gross valuation misstatement for the year in which the carryback or carryover of the deduction arises. Thus, by its terms, the regulation characterizes the penalty-bearing portion of the underpayment in the carryover or carryback year as ‘attributable to’ the gross valuation misstatement in the originating year.

**8. Contribution of facade conservation easements to facilitate zoning changes and development approval reduces the value of the contribution—and if you claim you got nothing in return, you get no deduction whatsoever.** Seventeen Seventy Sherman Street, LLC v. Commissioner, T.C. Memo. 2014-124 (6/19/14). The taxpayer contributed both exterior and interior facade conservation easements restricting the use of the burdened historic property, which was listed on a National Register of Historic Properties, to a qualified donee. Because the property was a designated landmark, proposed structural changes or material renovations to its exterior were subject to the approval of the Denver Landmark Preservation Commission. However, designation as a landmark did not obligate property owners to rehabilitate deteriorating structures, did not prohibit building demolition, and did not protect the interior of the building. Thus, the conservation easement provided stronger protections, such as building monitoring and prohibition of demolition, than designation as a landmark. The Tax Court (Judge Marvel) found that the conservation easements were granted in consideration of the City of Denver granting zoning changes and variances and approving a development plan for the property, and denied the deduction in its entirety—even though the IRS would have allowed a \$400,000 deduction, not the \$7,150,000 deduction claimed by the taxpayer. The taxpayer had not reported the receipt of any consideration for the contribution and did not treat it as a bargain sale. Accordingly, Judge Marvel reasoned that:

[W]hen a taxpayer grants a conservation easement as part of a quid pro quo transaction and fails to identify or value all of

the consideration received in the transaction, the taxpayer is not entitled to any charitable contribution deduction with respect to the grant of the conservation easement because he has failed to comply with section 170 and the regulations thereunder.

Because the taxpayer “failed to value all of the consideration . . . received in the quid pro quo exchange,” the court did not reach a conclusion on the value of the interior and exterior easements. Although the § 6662(h) gross valuation misstatement penalty asserted by the IRS was not upheld, because the IRS failed to establish that the value of the conservation easements claimed on the return (i.e., \$7,150,000) exceeded 400 percent of the correct value of the easements, a § 6662 negligence penalty was sustained, because the taxpayer did not follow its advisor’s advice to reduce the amount of the contribution to reflect the value of the consideration it received.

**9. Sometimes you see the disregarded entity, sometimes you don’t.** *RERI Holdings I, LLC v. Commissioner*, 143 T.C. No. 3 (8/11/14). RERI Holdings I, LLC contributed a successor membership interest in a single member LLC—a disregarded entity under the “check-the-box” regulations—to a university under a condition that the University not sell the property for two years but would sell it after two years. RERI Holdings valued the contribution based on an appraisal of the value of a hypothetical remainder interest in the disregarded LLC’s sole asset, real property subject to a triple net lease. The Tax Court (Judge Halpern) denied the IRS’s motion for summary judgment that: (1) the § 7520 tables for valuing remainder interests were not applied correctly to the valuation of the contribution and (2) the appraisal was not a “qualified appraisal” as defined in Reg. § 1.170A-13(c)(3). The IRS argued that it was improper to appraise a hypothetical remainder interest in the underlying real property rather than the LLC interest that was, in fact, donated to the university, taking the position that, assuming the § 7520 tables were applicable, the § 7520 remainder interest factor should have been applied to the fair market value of the contributed LLC interest. The court agreed with IRS that under the rationale of *Pierre v. Commissioner*, 133 T.C. 24 (2009), a disregarded entity is not disregarded in determining value of the contributed property, but denied the IRS’s motion for summary judgment on the ground that the value of the sole asset of an LLC might serve as an acceptable substitute for the LLC’s value, which was an issue that could not be resolved on summary judgment. The IRS also argued that Reg. § 1.7520-3(b)(2)(iii) precluded application of the § 7520 tables to determine the value of the LLC, because the holder of the LLC interest did not “enjoy the same protections as would be afforded . . . to a trust remainderman.” The IRS

asserted that the LLC interest could be devalued by depreciation of the real property, its sale, or additional or unpaid mortgage indebtedness, and thus the preservation and protection requirements of Reg. § 1.7520-3(b)(2)(iii) precluded application of the § 7520 tables. The IRS also argued that because of the two-year hold-sell requirement, the property was a restricted beneficial interest within the meaning of Reg. § 1.7520-3(b)(1)(ii) to which the § 7520 tables cannot be applied. The court again held that there were disputed material facts that affected whether the “preservation and protection” requirements in the § 7520 regulations had been met or whether the two-year hold-sell restriction was a “meaningful restriction” that would disqualify use of the § 7520 tables. Regarding the qualified appraisal issue, the court held that the appraisal of the remainder interest in the real property instead of the LLC did not automatically disqualify the appraisal. Although the appraisal did not include the hold-sell requirement, it did not omit any restriction that could have adversely impacted the value of the contributed property. While other aspects of the lease may have affected the accuracy of the appraisal, it was still “qualified.” Finally, failure to discuss mortgages, depreciation of the property, or a lessee’s rights to remove its property, while possibly resulting in an erroneous valuation of the donated property, are not items that would result in the appraisal not constituting a qualified appraisal under the regulations.

**10. A semi-secret conservation easement doesn’t harvest a deduction.** *Zarlengo v. Commissioner*, T.C. Memo. 2014-161 (8/11/14). The taxpayers executed a conservation easement deed to the National Architectural Trust in 2004, but the deed was not recorded until 2005. They claimed a charitable contribution deduction for 2004. The Tax Court (Judge Vasquez) held that the deduction was not allowed in 2004 because the conservation easement was not protected in perpetuity, as required by § 170(h)(2), until January 26, 2005, when the deed was recorded. Under the relevant state law (New York), an instrument purporting to create, convey, modify, or terminate a conservation easement is not effective unless recorded. The court went on to determine the value of the contribution, which was deductible in 2005, after evaluating the ubiquitous battle of the appraisers, and, because as usually happens the deduction allowed was much, much less than that claimed, § 6662 accuracy related penalties were sustained.

**11. Encouraging geriatrics to give away their retirement savings—does that make sense to you?** TIPA retroactively extended through 12/31/14 § 408(d)(8)(F), which allows taxpayers who are age 70-1/2 or older to make tax-free distributions to a charity from an IRA of up to \$100,000 per year. These distributions are not subject to the charitable contribution percentage limits.

**12. Let's go green for a few more years; contributions of conservation easements.** TIPA retroactively extended through 12/31/14 the provisions of § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher in tax years beginning after 12/31/05. Generally, under § 170(b), a corporation's charitable contribution deductions cannot exceed 10 percent of taxable income. An individual's deduction for qualified conservation easements cannot exceed 50 percent of the taxpayer's contribution base over other allowable charitable contribution deductions. For 2014, the limits under § 170(b) for deduction of qualified conservation easements by a farmer or rancher are 100 percent of the taxpayer's contribution base (in the case of an individual) or taxable income (in the case of a corporation) over other allowable charitable contributions, with a fifteen year carryforward.

**13. What part of "perpetuity" don't you understand?!** Belk v. Commissioner, 140 T.C. 1 (1/28/13). The taxpayers claimed a charitable contribution deduction for the grant of a conservation easement on 184.627 acres of a golf course to a qualified organization. Specifically, they agreed not to develop the golf course. However, the conservation easement agreement permitted the taxpayers, with the donee's consent, to remove portions of the golf course from the easement and replace them with property not theretofore subject to the conservation easement. The IRS disallowed the deduction, and the Tax Court (Judge Vasquez) upheld the IRS's disallowance of the deduction. Section 170(h)(1)(A) requires the contribution of a "qualified" real property interest, and to be a "qualified" real property interest, § 170(h)(2)(C) requires that the conservation easement limit in perpetuity the use that may be made of the property. Section 170(h)(2)(C) precluded the deduction because the taxpayers did not donate an interest in real property subject to a use restriction granted in perpetuity. Because the conservation easement agreement allowed the parties to change the property subject to the conservation easement, it did not meet the perpetuity requirement. The court rejected the taxpayers' argument the deduction nevertheless should be allowed because the substitution clause permitted only substitutions that would not harm the conservation purposes of the conservation easement. The court reasoned that the § 170(h)(5) requirement that the conservation purpose be protected in perpetuity is separate and distinct from the § 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity, and the taxpayers' conveyance failed to satisfy § 170(h)(2)(C). Satisfying § 170(h)(5) does not necessarily affect whether there is a qualified real property interest. Furthermore, it was argued that any substitution required the donee's consent: "There is nothing in the Code, the regulations, or the legislative history to suggest that section 170(h)(2)(C) is to be read to require that the interest in property donated be a restriction on the use of the real

property granted in perpetuity unless the parties agree otherwise. The requirements of section 170(h) apply even if taxpayers and qualified organizations wish to agree otherwise.”

- The IRS was represented in this case by one of Professor McMahon’s former research assistants. The Tax Court judge was one of Professor Shepard’s former research assistants. [So there, Marty!]

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

**b. The “plain language of the Code” sinks the taxpayers’ deduction, and a “savings clause” isn’t a life preserver.** Belk v. Commissioner, 114 A.F.T.R.2d 2014-6952 (4th Cir. 12/16/14). In an opinion by Judge Motz, the Fourth Circuit affirmed the Tax Court’s disallowance of the deduction. The court held that the plain language of § 170(h)(2)(C), which “provides that a ‘qualified property interest’ includes ‘a restriction (granted in perpetuity) on the use which may be made of the real property,’” “makes clear that a perpetual use restriction must attach to a defined parcel of real property rather than simply *some* or any (or interchangeable parcels of) real property.” (emphasis supplied by the court)

Because the taxpayers had the right to remove land from that defined parcel and substitute other land, the easement failed to qualify because the real property was not subject to a use restriction in perpetuity. Furthermore, allowing a deduction in these circumstances, where the borders of an easement could shift, would enable the taxpayers to bypass the requirement of Reg. § 1.170A-14(g)(5)(i) that the donor of a conservation easement make available to the donee “documentation sufficient to establish the condition of the property.” Finally, the court rejected the taxpayers’ argument that the deduction was preserved by a savings clause in the deed that the donee “shall have no right or power to agree to any amendments . . . that would result in this Conservation Easement failing to qualify . . . as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations.” Relying on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the court held the savings clause to be ineffective: “If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt.” Thus, the court declined to use the savings clause to rewrite the easement in response to its holding.

## X. TAX PROCEDURE

### A. Interest, Penalties, and Prosecutions

1. **The Tax Court refused to accept an accrual-method taxpayer’s year 2000 net operating loss, which the Justice Department had accepted for sentencing purposes in a tax fraud criminal prosecution that resulted in probation for a taxpayer with a prior bank fraud conviction for which he spent 20 months in prison.** Seiffert v. Commissioner, T.C. Memo. 2014-4 (1/9/14). The taxpayer used the accrual method of accounting to offset wage income with purported bad debts, but the only “proof” of the bad debts was a purported NOL which the Justice Department accepted for criminal sentencing purposes. In addition, the taxpayer failed to report 1099 income for the years in question. The Tax Court (Judge Kroupa) held that the criminal plea agreement did not establish the NOL for civil tax purposes, and that no collateral estoppel resulted from the government’s acceptance of the plea agreement. Judge Kroupa concluded that the statute of limitations had not expired for the 1996-2001 years in question because the taxpayer filed fraudulent returns for each of those years based upon her finding several badges of fraud (including understatement of income, inadequate and incomplete records, failure to cooperate, and inconsistent

explanations and incredible testimony), and upheld the Commissioner's determinations including the fraud penalty under § 6653.

**a. Motion for reconsideration denied.** Seiffert v. Commissioner, T.C. Memo. 2014-61 (4/7/14). The Tax Court (Judge Kroupa) denied motions for reconsideration and for revision of the decision at T.C. Memo. 2014-4 because she concluded that (1) collateral estoppel did not establish the NOL "because it was not an essential element of the criminal conviction to which the plea agreement related"; and (2) the plea agreement [with respect to the NOL] did not constitute "a factual admission" by the government.

**2. Is this circuit split worth a look by the Supremes, or is it just not political enough to grab their attention?** Carlson v. United States, 754 F.3d 1223 (11th Cir. 6/13/14). The Court of Appeals for the Eleventh Circuit held that the government's burden of proof in asserting a § 6701 penalty for aiding and abetting understatement of tax liability is "clear and convincing evidence," not merely a "preponderance of the evidence." Both the Second and Eighth Circuits have held that the government's burden of proof in asserting a § 6701 penalty is a "preponderance of the evidence." *Barr v. United States*, 67 F.3d 469 (2d Cir. 1995); *Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991).

**3. Instructions on how to rat yourself out.** Rev. Proc. 2014-15, 2014-5 I.R.B. 456 (1/23/14). This revenue procedure updates Rev. Proc. 2012-51, 2012-51 I.R.B. 719, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position.

**4. Does the Tax Court think it has jurisdiction? As long as the statute doesn't make clear that it doesn't, it sure does.** Corbalis v. Commissioner, 142 T.C. 46 (1/27/14). Judge Cohen held that the IRS's denial of a request to suspend interest under § 6404(g) is subject to review by the Tax Court under § 6404(h). Furthermore, Letters 3477 sent to the taxpayer by the IRS were final determinations for purposes of § 6404(h) even though the taxpayer's concurrent claims for abatement of interest under § 6404(e) were still pending.

**5. The Commissioner "gets Wherry and sick of tryin' it" because he could not prove by clear and convincing evidence that the taxpayer's underpayments were attributable to fraud because he counted more factors weighing against fraud than factors weighing in favor of fraud.** Carreon v. Commissioner, T.C. Memo. 2014-6 (1/9/14). As the result of an "agent-principal" scheme, the taxpayer underreported income for 2005 and 2006 by \$355,000 and \$101,000, respectively, by transferring those amounts to various so-called "trusts." The Tax Court (Judge Wherry) held that the taxpayer's reliance on the promoter of this scheme, while not reasonable, mitigated "slightly against a finding of civil fraud." On the other hand, inadequate maintenance of records weighed slightly in favor of a finding of fraud. Judge Wherry found three factors in favor of fraud, one neutral, and six factors against fraud, so the Commissioner failed to carry "his substantial burden of proving by clear and convincing evidence that [taxpayer] committed fraud." Therefore, the 75 percent civil fraud penalty under § 6663 was not upheld.

**6. To collect § 6672 trust fund penalty taxes, the IRS must prove that it provided notice to the taxpayer as required by § 6672(b); it cannot rely on the presumption of regularity.** United States v. Thomas, 113 A.F.T.R.2d 2014-1459 (N.D. Fla. 3/20/14). Section 6672(b) provides that, before the IRS can impose a § 6672 trust fund recovery penalty, it must notify the taxpayer in writing by mail or in person that the taxpayer will be subject to an assessment of the penalty. According to the Internal Revenue Manual, the IRS complies with this requirement by hand delivering or sending by certified mail a Letter 1153 to the taxpayer. In this case, the government claimed to have mailed a Letter 1153 to the taxpayer on October 15, 2012. To prove this, the government submitted "a copy of the electronically-maintained Form 1153 letter and a printout of the history log from the IRS' Automated Trust Fund Recovery . . . system." The government also submitted a declaration from a Revenue Officer "stating it is the IRS' standard practice to send a 1153 letter to a taxpayer by certified mail before assessing trust fund recovery penalties against him." The court agreed with the

taxpayer that, because the government was able to produce only an unsigned, undated copy of the Letter 1153 and produced no receipt demonstrating that it had been sent by certified mail, the government had failed to meet its burden of proving that the required notice had been sent. The court noted that a sister court had not applied the presumption of regularity in a prior decision involving nearly identical facts and that its decision had been affirmed by the Eleventh Circuit. See *Bonaventura v. United States*, 105 A.F.T.R.2d 2010-1039 (N.D. Ga. 2009), *aff'd per curiam*, 428 F. App'x 916 (11th Cir. 2011). Accordingly, the court granted the taxpayer's motion for summary judgment. The court observed that the period of limitations on assessment of the tax penalty had expired.

**7. A Knight's estate might be able to avoid late payment penalties by establishing reasonable cause based on erroneous advice from an attorney.** *Estate of John R.H. Thouron v. United States*, 752 F.3d 311 (3d Cir. 5/13/14). John R.H. Thouron, KBE,<sup>9</sup> the widower of Esther du Pont Thouron, died leaving a substantial estate. The estate tax return was due on 11/6/07. The estate timely filed a request for an automatic 6-month extension of time to file and made a payment of \$6.5 million, less than the \$20 million ultimately owed. The estate did not request an extension of time to pay, allegedly because of advice from its tax attorney concerning the estate's ability to elect under § 6166 to pay a portion of its estate tax liability in installments over several years. The estate filed its return in May 2008 and at that time requested an extension of time to pay. The estate did not make the election under § 6166 because it had concluded that it did not qualify. The IRS denied as untimely the request for an extension of time to pay and imposed a late payment penalty under § 6651(a)(2) of \$999,072 plus interest. The estate contested the penalty on the basis that § 6651(a)(2) grants relief from the penalty when the failure to pay is "due to reasonable cause and not due to willful neglect." The District Court granted summary judgment to the government, but the Third Circuit, in an opinion by Judge Ambro, reversed and remanded. The court relied on Reg. § 301.6651-1(c)(1) for the proposition that a taxpayer demonstrates reasonable cause by establishing that "he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date." Judge Ambro examined the Supreme Court's opinion in *United States v. Boyle*, 469 U.S. 241 (1985), and concluded that, although *Boyle* addresses establishing reasonable cause for failure to timely file a return, its holding also applies to establishing reasonable

---

9. The letters KBE are used to designate a person's status as Knight Commander, Order of the British Empire.

cause for failure to timely pay tax. In *Boyle*, Judge Ambro stated, the Supreme Court identified three distinct categories of cases: (1) those in which “a taxpayer relies on an agent for the ministerial task of filing or paying”; (2) those in which “in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the adviser erroneously told him was available”; and (3) those in which “an accountant or attorney advises a taxpayer on a matter of tax law.” Judge Ambro concluded that the facts of *Boyle* fell into the first category and that the Supreme Court had not addressed the remaining two categories. Thus, according to Judge Ambro, a taxpayer cannot establish reasonable cause by relying on an agent for the ministerial act of filing or paying, as in *Boyle*, but “a taxpayer’s reliance on the advice of a tax expert may be reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline.” Because there was a genuine issue of material fact as to the estate’s reliance on a tax expert’s advice, the Third Circuit reversed and remanded for further proceedings.

- The estate has brought legal action against its tax advisers. *Estate of John R.H. Thouron v. Cecil Smith & Associates, PC*, 2013 WL 56090 (E.D. Pa. 1/3/13).

**8. Well, well; a “marriage” of corporations isn’t the same as a marriage between individual “persons” for purposes of this Code section, it’s better.** *Wells Fargo & Co. v. United States*, 117 Fed. Cl. 30 (6/27/14). Section 6621(d) allows “global netting” on interest rates for tax overpayments and tax underpayments by the “same taxpayer” to address the disparity between the higher interest rate imposed on tax underpayments and the lower interest rate applied when the government pays a refund on tax overpayments. On a motion for summary judgment, the Court of Federal Claims (Judge Firestone) held that the term “same taxpayer” includes both predecessors of the surviving corporation in a statutory merger. Section 6621(d) allows interest netting regardless of whether the overlapping overpayments and underpayments involve corporations that were separate prior to the merger; following a merger, the entities become one and the same as a matter of law and thus become the “same” for purposes of interest netting. The court rejected the government’s argument that § 6621(d) netting applies only when the overpayment and underpayment were made by the taxpayer with the same TIN at the time of the payments.

**9. To establish a good faith reliance penalty defense, you have to prove that your tax advisor knew what he was doing.** *Wright v. Commissioner*, T.C. Memo. 2014-175 (8/28/14). The taxpayers, through a partnership, claimed a \$3,000,000 loss generated through transactions

involving a series of euro put and call options, with two of the put options being donated to a charity. The loss depended on the options being marked-to-market under § 1256(c) as a foreign currency contract as defined in § 1256(g)(2). In an earlier proceeding, *Wright v. Commissioner*, T.C. Memo. 2011-292, the Tax Court determined that the options were not foreign currency contracts. The issue in the instant proceeding was whether to sustain a § 6662(a) accuracy-related penalty. The taxpayers argued that they relied reasonably and in good faith on a tax-advisor law firm's tax opinion stating that the loss was "'more likely than not' to be 'upheld by a court if challenged by the IRS and fully litigated on the merits.'" The court (Judge Foley) rejected their good faith reliance defense on two grounds. First, the opinion stated that the law firm relied upon certain "representations and advice" provided to it by the partnership and that the opinion could not be relied on if such representations and advice were "inaccurate in any material respect, or prove not to be authentic," and a letter to the partnership transmitting the tax opinion stated that "[w]hile we are furnishing you the opinion letter, please be advised that the opinion letter may not be relied upon (and is not otherwise released) unless and until we have the Investor Representations fully executed by you." Although the law firm reviewed a copy of unsigned investor representations, the executed investor representations were never delivered. Second, the law firm did not have significant experience relating to the taxation of foreign currency options. The lawyer who prepared the opinion "lacked the requisite tax expertise to justify petitioners' reliance." The "law firm based its opinion that a foreign currency option constitutes a foreign currency contract primarily on its interpretation of section 1256. This interpretation, however, was not well reasoned and ignored the plain language of the statute." Thus, their reliance was "unreasonable."

## B. Discovery: Summonses and FOIA

1. **You can't hide your foreign bank account records behind the Fifth Amendment.** *M.H. v. United States*, 648 F.3d 1067 (9th Cir. 8/19/11), *cert. denied*, 133 S. Ct. 26 (6/25/12). M.H. was the target of a grand jury investigation seeking to determine whether he used secret Swiss bank accounts to evade paying federal taxes. The District Court granted a motion to compel his compliance with a grand jury subpoena *duces tecum* demanding that he produce certain records related to his foreign bank accounts. The District Court declined to condition its order compelling production upon a grant of limited immunity and, pursuant to the recalcitrant witness statute, 28 U.S.C. § 1826, held him in contempt for refusing to comply. The Ninth Circuit upheld the District Court order. The Court of Appeals held that "[b]ecause the records sought through the subpoena fall under the Required Records Doctrine, the Fifth Amendment privilege against self-incrimination is

inapplicable, and M.H. may not invoke it to resist compliance with the subpoena's command." The records were required to be kept pursuant to the predecessor of 31 C.F.R. § 1010.420.

- The opinion stated:

There is nothing inherently illegal about having or being a beneficiary of an offshore foreign banking account. According to the Government, § 1010.420 applies to "hundreds of thousands of foreign bank accounts—over half a million in 2009." Nothing about having a foreign bank account on its own suggests a person is engaged in illegal activity. That fact distinguishes this case from *Marchetti* and *Grosso*, where the activity being regulated—gambling—was almost universally illegal, so that paying a tax on gambling wagers necessarily implicated a person in criminal activity. Admitting to having a foreign bank account carries no such risk. That the information contained in the required record may ultimately lead to criminal charges does not convert an essentially regulatory regulation into a criminal one.

**a. When the government asks, ya gotta pony up the name(s) on your foreign bank accounts, the account numbers, the name and address of the banks, the type of account, and the maximum value of each such account during each year.** In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011, 691 F.3d 903 (7th Cir. 8/27/12), *cert. denied*, 133 S. Ct. 2338 (5/13/13). In an opinion by Judge Bauer, the Seventh Circuit held that the compulsory production of foreign bank account records required to be maintained under the Bank Secrecy Act of 1970 did not violate a taxpayer's Fifth Amendment privilege against self-incrimination. The required records doctrine overrode any act of production privilege. A grand jury subpoena seeking the taxpayer's bank records issued in connection with an investigation into whether he used secret offshore bank accounts to evade his federal income taxes was enforced.

**b. A third decision going the same way.** In re: Grand Jury Subpoena, 696 F.3d 428 (5th Cir. 9/21/12). The Fifth Circuit (Judge Dennis), in reversing a district court, declined to create a circuit split and held that the required records doctrine applied; the individual was required to produce foreign bank records subpoenaed in the IRS's investigation into whether he used secret Swiss bank accounts [with UBS] to evade his federal income taxes. The court's reasoning was that the Bank Secrecy Act's (BSA)

record-keeping requirement is “essentially regulatory,” the records sought are of a kind “customarily kept” by account holders, and the records have assumed “public aspects”; this is so even though one purpose of the BSA was to aid law enforcement officials in pursuing criminal investigations.

**c. The Second Circuit held that owners of secret offshore foreign bank accounts are not “inherently suspect” of tax evasion or of anything else illegal.** In re: Grand Jury Subpoena Dated February 2, 2012, 741 F.3d 339 (2d Cir. 12/19/13). The Second Circuit (Judge Wesley) held that the required records exception to the Fifth Amendment applied, and that production of foreign bank records was required. Judge Wesley stated:

The record keeping regulation at issue here, 31 C.F.R. section 1010.420, targets those engaged in the lawful activity of owning a foreign bank account. “There is nothing inherently illegal about having or being a beneficiary of an offshore foreign bank account.” M.H., 648 F.3d at 1074. Doe’s protestations notwithstanding, owners of these accounts are not “inherently suspect” and the statute is “essentially regulatory.”

Doe’s argument that the statute is criminally focused has some force. The BSA [Bank Secrecy Act] declares that its purpose is “to require certain reports or records where they have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism.” 31 U.S.C. section 5311. It does list “criminal investigations” first, but this multifaceted statute clearly contributes to civil and intelligence efforts wholly unrelated to any criminal purpose.

Although portions of the statute’s legislative history support Doe’s characterization of the BSA as focused on criminal activity, “[t]he Supreme Court has already considered and rejected these arguments as they relate to the BSA generally.” M.H., 648 F.3d at 1074 (citing *Cal. Bankers’ Ass’n v. Shultz*, 416 U.S. 21, 76-77 (1974)). Moreover, “the question is not whether Congress was subjectively concerned about crime when enacting the BSA’s recordkeeping and reporting provisions, but rather whether these requirements apply exclusively or almost exclusively to people engaged in criminal activity.” *Grand Jury Proceedings*, No. 4-10, 707 F.3d at 1271; accord *Grand Jury Subpoena*, 696 F.3d at 434.

Looking beyond “Congressional subjective intent”—if there could be such a thing—the BSA has considerable regulatory utility outside of the criminal justice context.

The question becomes whether a statute with mixed criminal and civil purposes can be “essentially regulatory” with respect to the required records exception. We agree with our sister circuits: the fact “[t]hat a statute relates both to criminal law and to civil regulatory matters does not strip the statute of its status as ‘essentially regulatory.’” Grand Jury Proceedings, No. 4-10, 707 F.3d at 1270. Because people owning foreign bank accounts are not inherently guilty of criminal activity, the BSA’s applicable recordkeeping requirement, designed to facilitate “criminal, tax, or regulatory investigations or proceedings, or [] the conduct of intelligence or counterintelligence activities,” 31 U.S.C. section 5311, is still essentially regulatory. (footnote omitted)

- These were records that were routinely maintained and made available to government agents upon request by those German Jews who held secret accounts in Swiss banks during the 1930s and 1940s.

**d. No circuit conflicts yet; the fifth case was from the Fourth Circuit.** United States v. Under Seal, 737 F.3d 330 (4th Cir. 12/13/13). The Fourth Circuit (Judge Agee) agreed with the other circuits that have dealt with this issue, and held that the required records doctrine overrode the Fifth Amendment privilege against self-incrimination of a couple who held an account (successively) in two Swiss private banks.

**2. Will the Supreme Court tell us how a witness can meet his burden in demonstrating that an IRS subpoena was issued for an improper purpose when the district court permitted him neither discovery nor an evidentiary hearing?** United States v. Clarke, 517 F. App’x 689 (11th Cir. 4/18/13), *vacating and remanding per curiam* 111 A.F.T.R.2d 2013-1697 (S.D. Fla. 4/16/12), *cert. granted*, 134 S. Ct. 895 (1/10/14). Michael Clarke, the Chief Financial Officer of Beekman Vista, Inc., was issued an IRS summons with respect to the examination of Dynamo Holdings Limited Partnership (“DHLP”) for its 2005, 2006, and 2007 years. The summons was issued on 10/28/10, which was prior to the issuance to DHLP by the IRS of a Notice of Final Partnership Administrative Adjustment (“FPAA”) on 12/28/10, and prior to the filing by DHLP of a Tax Court petition

on 2/1/11. The district court heard argument on Clarke's motion to dismiss the summons but declined to grant discovery or an evidentiary hearing. The district court enforced the summons when it found Clarke's answer to the summons to be inadequate to overcome the apparent regularity of the summons proceeding under the holding in *United States v. Powell*, 379 U.S. 48 (1964). That answer contained the allegation that the summons was issued because the government was "displeased that DHLP declined to extend its statute of limitations period," which the district court dismissed as "mere conjecture unsupported by evidence." The Eleventh Circuit agreed with the district court that the *Powell* requirements had been met by the IRS with its prima facie showing of the four required elements:

To obtain enforcement of a summons, the IRS must make a four-part prima facie showing that (1) "the investigation will be conducted pursuant to a legitimate purpose," (2) "the inquiry may be relevant to the purpose," (3) "the information sought is not already within the Commissioner's possession," and (4) "the administrative steps required by the Code have been followed." *United States v. Powell*, 379 U.S. 48, 57-58, 85 S. Ct. 248, 13 L. Ed. 2d 112 (1964); see also *Nero Trading, LLC v. U.S. Dep't of Treasury, IRS*, 570 F.3d 1244, 1248 (11th Cir. 2009).

However, the Eleventh Circuit held that Clarke's allegation of improper purpose entitled him to an evidentiary hearing during which he could question IRS officials concerning the reasons for issuing the summons:

Under our precedents, Appellants were entitled to a hearing to explore their allegation of an improper purpose.<sup>3</sup> As we have explained, in situations such as this, requiring the taxpayer to provide factual support for an allegation of an improper purpose, without giving the taxpayer a meaningful opportunity to obtain such facts, saddles the taxpayer with an unreasonable circular burden, creating an impermissible "Catch 22." See *Nero*, 570 F.3d at 1250; *S.E. First Nat'l Bank*, 655 F.2d at 667. While "the scope of any adversarial hearing in this area is left to the discretion of the district court," binding Circuit authority requires that Appellants be given an opportunity "to ascertain whether the Service issued a given summons for an improper purpose." *Nero*, 570 F.3d at 1249. As required by *Southeast First National Bank*, on remand Appellants should be permitted to "question IRS officials

concerning the Service's reasons for issuing the summons[es]." 655 F.2d at 667 (footnote omitted).

<sup>3</sup>Appellants, however, are not entitled to discovery. We have held that the full "panoply of expensive and time-consuming pretrial discovery devices may not be resorted to as a matter of course and on a mere allegation of improper purpose." *Nero*, 570 F.3d at 1249 (internal quotation and emphasis omitted).

- There has been some speculation that certiorari to the Eleventh Circuit was granted in order that the Supreme Court might re-examine its holding in *United States v. Powell*, 379 U.S. 48 (1964), in which the Court (Mr. Justice Harlan) stated:

Reading the statutes as we do, the Commissioner need not meet any standard of probable cause to obtain enforcement of his summons, either before or after the three-year statute of limitations on ordinary tax liabilities has expired. He must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed—in particular, that the "Secretary or his delegate," after investigation, has determined the further examination to be necessary and has notified the taxpayer in writing to that effect. This does not make meaningless the adversary hearing to which the taxpayer is entitled before enforcement is ordered. At the hearing he "may challenge the summons on any appropriate ground," *Reisman v. Caplin*, 375 U.S. 440, at 449, 84 S. Ct. at 513. Nor does our reading of the statutes mean that under no circumstances may the court inquire into the underlying reasons for the examination. It is the court's process which is invoked to enforce the administrative summons and a court may not permit its process to be abused. Such an abuse would take place if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation. The

burden of showing an abuse of the court's process is on the taxpayer, and it is not met by a mere showing, as was made in this case, that the statute of limitations for ordinary deficiencies has run or that the records in question have already been once examined.

379 U.S. at 57–58 (footnotes omitted).

**a. Turnabout is fair play. Summoned individuals might have the right to grill IRS agents regarding their motives in issuing the summons.** United States v. Clarke, 134 S. Ct. 2361 (6/19/14). In the course of a partnership audit, the IRS issued a summons to four individuals associated with the partnership whom the IRS believed had information and records relevant to the audit. The individuals refused to comply and the IRS sought enforcement of the summons. In the enforcement proceedings, the summoned individuals asserted that the IRS had issued the summons for an improper purpose, namely to punish the partnership for refusing to extend the statute of limitations, and sought enforcement for an improper purpose; specifically, that the IRS decided to enforce the summonses, subsequent to the partnership filing suit in Tax Court, to “evad[e] the Tax Court[’s] limitations on discovery” and thus gain an unfair advantage in that litigation. In support of their request for an opportunity to question the IRS agents about their motives, the summoned individuals submitted an affidavit from the attorney of another partnership associate, who had complied with a summons issued at the same time, which reported that only the IRS attorneys handling the Tax Court case, and not the original investigating agents, were present at the interview of his client. The District Court denied the request and ordered compliance, but the Eleventh Circuit reversed, 517 Fed. App’x 689 (11th Cir. 4/18/13), finding that the District Court’s refusal to allow the summoned individuals to examine IRS agents constituted an abuse of discretion. In support of that ruling, the Court of Appeals cited Fifth Circuit precedent holding that a simple “allegation of improper purpose,” even if lacking any “factual support,” entitles a taxpayer to “question IRS officials concerning the Service’s reasons for issuing the summons.” The Supreme Court, in a unanimous opinion by Justice Kagan, vacated the Court of Appeals decision and remanded the case. After initially repeating that under *United States v. Powell*, 379 U.S. 862 (1981), and its progeny, “summons enforcement proceedings are to be ‘summary in nature,’” and “that courts may ask only whether the IRS issued a summons in good faith, and must eschew any broader role of ‘oversee[ing] the [IRS’s] determinations to investigate,’” and “absent contrary evidence, the IRS can satisfy that standard by submitting a simple affidavit from the investigating agent,” the Court went on to hold as follows:

As part of the adversarial process concerning a summons's validity the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some credible evidence supporting his charge. But circumstantial evidence can suffice to meet that burden; after all, direct evidence of another person's bad faith, at this threshold stage, will rarely if ever be available. And although bare assertion or conjecture is not enough, neither is a fleshed out case demanded: The taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive. That standard will ensure inquiry where the facts and circumstances make inquiry appropriate, without turning every summons dispute into a fishing expedition for official wrongdoing. And the rule is little different from the one that both the respondents and the Government have recommended to us.

The Court went on to remind that (1) the appellate court review of the District Court's decision is for abuse of discretion, but that the "District Court's decision is entitled to deference only if based on the correct legal standard," and (2) the District Court's latitude does not extend to legal issues about what counts as an illicit motive. Finally, the Court specifically declined to opine on whether either of the asserted improper motives for issuance of the summons actually were improper.

- While the taxpayer got a partial victory in Clarke, perhaps the most important aspect of the decision is the reaffirmation of the breadth of the IRS's summons power under *Powell* and its progeny.

**3. Did the Tax Court just say that anytime the taxpayer raises a § 6664(c)(1) penalty defense attorney client privilege has been waived?** AD Investment 2000 Fund LLC v. Commissioner, 142 T.C. No. 13 (4/16/14). In a Son-of-Boss Tax Shelter case, the IRS, in anticipation of the taxpayers raising reasonable cause and good faith affirmative defenses to § 6662 accuracy-related penalties, moved to compel production of the taxpayers' attorneys' opinion letters regarding whether it was more likely than not that anticipated tax benefits from the transactions in question would be upheld. The taxpayers claimed attorney-client privilege. But the IRS argued that the taxpayers impliedly waived privilege by asserting: "Any underpayment of tax was due to reasonable cause and with respect to which the Partnership and its partners acted in good faith." (I.R.C. § 6664(c)(1)).

However, the taxpayers denied that these averments brought “professional advice (i.e., the opinions) into question.” The IRS conceded that the taxpayers raised only self-determination, and not reliance on professional advice, to show that they satisfied the good-faith belief requirement, but argued, that the taxpayers had “placed the opinions into controversy by relying on a reasonable cause, good-faith defense and by putting the partnerships’ beliefs into issue.” The Tax Court (Judge Halpern) agreed with the IRS, stating:

When a person puts into issue his subjective intent in deciding how to comply with the law, he may forfeit the privilege afforded attorney-client communications. . . . “[A] client waives his attorney privilege when he brings suit or raises an affirmative defense that makes his intent and knowledge of the law relevant.”

The opinion continued:

Petitioners’ averments that the partnerships satisfied the belief requirement by the first method put into dispute the partnerships’ knowledge of the pertinent legal authorities. Petitioners’ averments also put into contention the partnerships’ understanding of those legal authorities and their application of the legal authorities (i.e., the law) to the facts. Finally, the averments put into contention the basis for the partnerships’ belief that, if challenged, their tax positions would more likely than not succeed in the courts. Petitioners have thus placed the partnerships’ legal knowledge, understanding, and beliefs into contention, and those are topics upon which the opinions may bear. If petitioners are to rely on the legal knowledge and understanding of someone acting for the partnerships to establish that the partnerships reasonably and in good faith believed that their claimed tax treatment of the items in question was more likely than not the proper treatment, it is only fair that respondent be allowed to inquire into the bases of that person’s knowledge, understanding, and beliefs including the opinions (if considered).

Thus, the taxpayers had “forfeited the privilege that would otherwise apply to the opinions.” Judge Halpern ordered the opinions to be produced and warned that in the event of noncompliance, he would consider prohibiting the taxpayers from introducing evidence that they met the good-faith “belief

requirement by self-determination or that someone acting for the partnerships had a good-faith and honest misunderstanding of law.”

**4. While many of us are still undecided on the post-Clintonian meaning of “is,” the Tenth Circuit in a 2-1 decision held that “shall” means “shall.”** *Jewell v. United States*, 749 F.3d 1295 (10th Cir. 4/28/14). This appeal from decisions in the Eastern and Western Districts of Oklahoma, which quashed and upheld, respectively, four IRS summonses to banks for records involving nursing homes owned by Mr. Jewell in light of the admitted failure of the IRS to give him the 23-day notice period required by the third-party summons provision of § 7609(a)(1) and *United States v. Powell*, 379 U.S. 48, 57 (1964), resulted in the quashing of all four summonses on the ground that the word “shall” in the statute made such notice mandatory. (The district court that upheld the summonses “not[ed]” that taxpayer received the summonses in time to file his petition, while the district court that quashed the summonses “reason[ed]” that the IRS failed to comply with the notice requirement.) The Tenth Circuit (Judge Bacharach) stated that it was upholding “the age-old precept that ‘shall’ means ‘shall,’ while being ‘mindful of the fact that five other circuit courts have declined to apply *Powell* in this manner.’”

- Judge Tymkovick dissented on the ground that he did “not believe that *Powell* imposes a *per se* bar on enforcement in the event the IRS commits a technical breach of an administrative provision” of the Code, but would “consider whether, under the totality of the circumstances, a court should decline to enforce a summons.”

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

- The work product claim was based on the so-called “EY Tax Memo,” which was a 321 page document that was provided to the court for *in camera* review. It “expounds on the transactional steps that [E&Y] provided” and “contains numerous appendices that provide detailed

analysis of the federal tax issues implicated by each step.” Magistrate Judge Gorenstein continued:

This legal analysis makes reference to statutes, IRS regulations, IRS private letter rulings, other administrative materials, and case law. In many instances, the memorandum asserts that there is no law clearly on point and thus uses language such as “although not free from doubt,” “the better view is that,” “it may be argued,” and “it is not inconceivable that the IRS could assert.” Additionally, in explaining its recommendations for handling particular aspects of the restructuring and refinancing measures, the memorandum considers at great length the arguments and counter-arguments that could be made by Schaeffler and the IRS with regard to the appropriate tax treatment of these measures. While there is copious citation to relevant legal authority, the memorandum does not specifically refer to litigation—for example, by discussing what actions peculiar to the litigation process Schaeffler or the IRS might take or what settlement strategies might be considered. Rather, the memorandum contains detailed and thorough legal analysis as to the propriety of the planned measures and advocates what specific transactional steps should be taken. . . .

We will also accept that Schaeffler believed that litigation was highly probable in light of the significant and difficult tax issues that were raised by the planned refinancing and restructuring. Accordingly, the Court is called upon to make the factual determination required by *Adlman* [*United States v. Adlman*, 134 F.3d 1194, 1196 (2d Cir. 1998)]: whether this memorandum and the related documents “would have been created in essentially similar form” had litigation not been anticipated. 134 F.3d at 1202. While we have described this as a factual determination, in reality it is a counterfactual determination because it requires the Court to imagine what “would have” happened in a world where Schaeffler did not anticipate litigation as to the restructuring and refinancing transactions but everything else was exactly the same—in other words, Schaeffler still found himself acquiring the unexpectedly large share of Conti stock and still needed to engage in a refinancing and restructuring arrangement that would comply with federal tax laws. . . .

Accordingly, given our assumption that Schaeffler is a rational businessperson who routinely makes efforts to

comply with the law, we find that, even had he not anticipated an audit or litigation with the IRS, he still would have had to obtain the type of legal assistance provided by Ernst & Young to carry out the refinancing and restructuring transactions in an appropriate manner. . . .

As to whether Ernst & Young's advice would have been different in content or form had it known that no audit or litigation would ensue, petitioners have presented no facts suggesting that Ernst & Young would have acted any differently. To the contrary, as petitioners recognize, see Letter from M. Todd Welty, dated May 2, 2014 (Docket #52) ("Welty Letter"), **there exists legal authority demanding that tax practitioners not allow the possibility that a tax return will remain unaudited to affect the advice they give.** Treasury Department Circular 230 states:

In evaluating the significant Federal tax issues addressed in [a tax opinion], the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

[Former] Circular 230, § 10.35(c)(3)(iii). Similarly, a Treasury regulation regarding tax shelters states that in reaching conclusions regarding whether a particular tax position would more likely than not be sustained on its merits,

the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account.

26 C.F.R. § 1.6694-2(b). In other words, when tax practitioners give advice to clients, they must ignore the actual possibility of an audit—and, by extension, litigation—in opining on the tax implications of a transaction. Thus, when providing legal advice on the tax treatment of the restructuring and refinancing transactions, the Ernst & Young advisors had a responsibility to consider in full the relevant

legal issues regardless of whether they anticipated an audit and ensuing litigation with the IRS.

• Magistrate Judge Gorenstein concluded on the work product issue:

Thus, we conclude that had Schaeffler's tax advisors been asked to opine on the legal implications of the transactions with the knowledge that an audit or litigation would not occur, they "would have" used the same methodology to render tax advice: that is, a close analysis of the relevant legal authorities to determine how various tax positions would be tested in the crucible of litigation.

For these reasons, we find that the EY Tax Memo, as well as the related responsive documents, would have been produced in the same form irrespective of any concern about litigation. Accordingly, these documents are not protected from disclosure under the work product doctrine.

**6. Who will be looking at the information your client provided in response to a summons and asking your client questions during the summons interview? It might not be an IRS employee.** T.D. 9669, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 79 F.R. 34625 (6/18/14). Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage, and reproduction) related to returns or return information. The Treasury has issued proposed and temporary regulations clarifying that such persons with whom the IRS or Chief Counsel contracts for services:

may receive and examine books, papers, records, or other data produced in compliance with [a] summons [issued by the IRS] and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of the witness summoned by the IRS to provide testimony under oath.

The proposed and temporary regulations state that full participation in an interview includes "being present during summons interviews; questioning the person providing testimony under oath; and asking a summoned person's representative to clarify an objection or assertion of privilege." The temporary regulations apply to summons interviews conducted on or after 6/18/14.

- The Tax Section of the State Bar of Texas has submitted comments on the proposed regulations in which the Tax Section recommends that the Treasury remove the provision that permits persons providing services to question a witness under oath or ask the witness's representative to clarify an objection or assertion of privilege. Removing this provision, the Tax Section states, would "result in a more orderly proceeding and a cleaner, more comprehensible transcript of the interview" and also "avoid the unsettled question of whether a private contractor has the legal authority to examine a witness." *Texas Bar Suggests Amendment to Proposed Summons Interview Regs*, 2014 TAX NOTES TODAY 180-24 (9/16/14).

**7. High tech discovery response is approved by the Tax Court.** Dynamo Holdings Limited Partnership v. Commissioner, 143 T.C. No. 9 (9/17/14). The IRS sought to have the taxpayer produce electronically stored information contained on two backup storage tapes or, alternatively, the tapes themselves (or copies thereof). The taxpayer acknowledged that the tapes contained tax-related information but asserted that it would take many months and cost at least \$450,000 to fulfill the request because it would need to review each document on the tapes to identify what is responsive and then withhold privileged or confidential information. The taxpayer also requested the court to deny the IRS's motion as a "fishing expedition" in search of new issues that could be raised in this or other cases. Alternatively, the taxpayer requested that it be allowed to use predictive coding, a technique prevalent in the technological industry but not yet formally sanctioned by the Tax Court, to efficiently and economically identify the nonprivileged information responsive to the IRS's discovery request. The Tax Court (Judge Buch) granted the IRS's motion requiring the taxpayer to respond to the discovery request but allowed the taxpayer to use predictive coding in doing so.

### C. Litigation Costs

**1. "[U]nder the 'narrow statutory language of section 7430(c)(7)', as well as the Commissioner's interpretive regulations taxpayers \*\*\* who do a good job at the administrative level of resolving issues and getting respondent to realize the error of his ways are precluded from recovering administrative costs incurred in achieving those favorable results."** Purciello v. Commissioner, T.C. Memo. 2014-50 (3/24/14). The IRS abated its claim against the taxpayer for § 6672 penalty taxes at the Appeals Office and the taxpayer sought to recover administrative costs. Although the taxpayer clearly had substantially prevailed in the administrative proceeding, the Tax Court (Judge Jacobs) denied the request

for costs. Even if a taxpayer substantially prevails, the taxpayer is not treated as the prevailing party if the IRS establishes that the

position of the United States” was substantially justified. Section 7430(c)(7)(B) provides “the ‘position of the United States’ taken in an administrative proceeding is the position the IRS takes as of the earlier of (i) the date of the receipt by the taxpayer of the notice of the decision of the Internal Revenue Service Office of Appeals or (ii) the date of the notice of deficiency.

Judge Jacobs agreed with the IRS’s argument that the taxpayer was not a prevailing party because the IRS Appeals Office conceded the case and agreed that the taxpayer did not owe any money to the IRS, and for purposes of § 7430, this position was the first time the United States took a position in the case and, “inasmuch as respondent agreed with petitioner’s contention, the position taken by the United States was substantially justified.”

**2. It’s hard for the government to deny that the taxpayer is entitled to costs as a prevailing party when it concedes that its assessment was invalid and that its collection action should not be sustained.** *Swiggart v. Commissioner*, T.C. Memo. 2014-172 (8/25/14). On his individual return for 2010, the taxpayer claimed head of household status and paid with the return \$2,149 less than the tax liability shown on the return. The IRS issued a notice of summary assessment of the unpaid \$2,149 and an additional \$2,205 (including tax, a late payment penalty under § 6651(a)(2), and interest) on account of a mathematical error. The notice stated that the additional amount assessed resulted from the IRS changing the taxpayer’s filing status to single because the name of the dependent who qualified him for head of household filing status was not reported on the tax return. The IRS soon followed with a Final Notice of Intent to Levy and Notice of Your Right to a Hearing, in which it sought to collect the amount allegedly due plus penalties and interest. Forty-six days after the IRS issued the notice of summary assessment, the taxpayer’s attorney mailed by certified mail both a request for abatement and a Form 12153, Request for a Collection Due Process or Equivalent Hearing. The attorney included with the Form 12153 a detailed supporting statement. The IRS responded with a letter stating that it was unable to process the claim for abatement because the taxpayer’s supporting information was not complete and the additional information the taxpayer provided did not give the IRS a basis to change the assessment. During the CDP hearing, the taxpayer provided an affidavit in which he identified his child by name and Social Security number and stated that, although he had an agreement with the child’s mother to waive the dependency exemption

deduction for certain years, including 2010, his child had spent the greater number of nights in 2010 with him. Although the settlement officer agreed that claiming the child as a dependent was not required to qualify as a head of household, the settlement officer concluded that he could not abate the tax attributable to the change in filing status until the taxpayer provided additional documents showing that the child had lived with him for more than half of the year. The IRS then issued a notice of determination sustaining the proposed levy because the taxpayer had not proven that he was entitled to head of household filing status. The taxpayer challenged the notice of determination by filing a petition in the Tax Court. The taxpayer moved for summary judgment, asking the court to conclude that the portion of the assessment attributable to the change in filing status was void and that the IRS could not levy to collect that portion. The IRS conceded that the taxpayer's motion for summary judgment should be granted as to the portion of the assessment attributable to the change in filing status and entered into a stipulation of settled issues in which the parties agreed that the IRS had abated \$2,142 of the assessment (without prejudice to the IRS's right to reassess the amount using deficiency procedures). After trial, the taxpayer moved for reasonable administrative and litigation costs pursuant to § 7430, which permits the award of such costs to a prevailing party. The IRS conceded that the taxpayer had exhausted administrative remedies and had not unreasonably protracted the proceedings, and therefore the only issue was whether the taxpayer was a prevailing party. To be a prevailing party, a taxpayer must substantially prevail with respect to either the amount in controversy or the most significant issue or set of issues presented and also meet certain timing and net worth requirements. The IRS conceded, and the court (Judge Buch) concluded, that the taxpayer met the timing and net worth requirement. The court also concluded that the taxpayer had substantially prevailed. The court noted that the taxpayer had consistently disputed the portion of the assessment attributable to the unilateral change in filing status, that the only issues presented were the validity of that portion of the assessment and the attempts to collect based on that assessment, and that the IRS had conceded these issues. The government argued that, under § 7430(c)(4)(B), the taxpayer could not be treated as the prevailing party because the government's position was substantially justified. The court rejected this argument. It noted that the taxpayer had requested abatement within 60 days of the issuance of the math error notice and therefore, under § 6213(b)(2)(A), the IRS was required to abate the assessment, which it had failed to do. Instead, the court observed, the IRS had taken the position both by letter and in the CDP hearing that it would not abate the assessment because the taxpayer had failed to prove he was entitled to head of household filing status. "By statute, the IRS was required to abate the assessment, and requiring [the taxpayer] to prove entitlement to head of household status before abating the assessment was not substantially

justified.” The court awarded administrative costs and attorneys’ fees, but reduced the hourly rate for the attorneys’ fees from the requested \$250 per hour to the statutory rate (\$180 or \$190 per hour for the years involved).

#### **D. Statutory Notice of Deficiency**

There were no significant developments regarding this topic during 2014.

#### **E. Statute of Limitations**

**1. Only part of the § 6501(e) regulations was invalidated in *Home Concrete & Supply*.** *Barkett v. Commissioner*, 143 T.C. No. 6 (8/28/14). The Tax Court (Judge Goeke) held that gains, as argued by the IRS, and not the total amount realized on a sale of investment assets, as argued by the taxpayer, are used to determine whether there was an omission from gross income that triggered the six-year limitations period in § 6501(e). The Supreme Court’s decision in *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), invalidating in part Reg. § 301.6501(e)-1, did not change the result in *Insulglass Corp. v. Commissioner*, 84 T.C. 203 (1985), in which the Tax Court held that

capital gains, and not the gross proceeds, are to be treated as the “amount of gross income stated in the return” for purposes of section 6501(e) . . . on the basis of section 61(a), which defines gross income as “all income from whatever source derived,” including “[g]ains derived from dealings in property.”

#### **F. Liens and Collections**

**1. BLIPS and bankruptcy: hiding assets after learning losses may be disallowed can make the subsequent tax liability non-dischargeable.** *Vaughn v. United States*, 111 A.F.T.R.2d 2013-1481 (D. Colo. 3/29/13). The taxpayer used losses from a KPMG BLIPS tax shelter to offset gain from the 1999 sale of his interest in a cable company. After being informed by KPMG of the release of Notice 2000-44, 2000-2 C.B. 255, which identified losses in BLIPS-type tax shelters as nondeductible, and learning that the IRS was auditing the cable company’s former CFO, who also had used BLIPS losses to offset gain, the taxpayer purchased a \$1.7 million home titled in his fiancée’s name. After KPMG advised the taxpayer to disclose his BLIPS investment, but before he disclosed it, the taxpayer funded a \$1.5 million trust

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

**a. Best not squander those tax shelter savings before audit and assessment.** In re Vaughn, 765 F.3d 1174 (10th Cir. 8/26/14). The Court of Appeals, in an opinion by Judge McKay, affirmed the lower court's holdings. Vaughn "'must have been aware' of the circumstances demonstrating the invalidity of his BLIPS losses, and [he] chose to claim those losses on his tax returns and to deplete his remaining assets, 'knowing, as he must have, the BLIPS investment constituted an improper abusive tax shelter.'"

**2. The government successfully detains taxpayers for failing to return a fraudulent tax refund.** United States v. Barrett, 113 A.F.T.R.2d 2014-749 (D. Colo. 1/29/14). The taxpayers, a married couple, filed a fraudulent tax return for the 2007 tax year that resulted in a \$217,615 tax refund to which they were not entitled. The government brought this action in which it alleged that the taxpayers had removed funds from the United States and sought an order requiring the funds to be repatriated and applied to their tax debt.

In an effort to identify assets available for application to the debt, and to collect such assets, the United States . . . filed an ex parte sealed motion for the issuance of a writ of ne exeat republica against the Barretts. . . . A writ of ne exeat republica is a form of injunctive relief ordering the person to whom it is addressed not to leave the jurisdiction of the court or the state, for example, to aid the sovereign to compel a citizen to pay his taxes.

At an evidentiary hearing, the government introduced evidence of assets held by the taxpayers outside the United States. The court characterized these

assets—which included a bank account with a balance of \$60, used office furniture, and a horse with unknown value—as “dribs and drabs.” Nevertheless, because the assets identified by the government would allow the debt to be reduced by \$16,000 and also included a 50 percent interest in real property in Ecuador that was purchased for \$64,000, the court declined to discharge the writ until the taxpayers pay \$16,000 and either sell the real property and provide the proceeds to the government or prove, with credible evidence, that they cannot sell it. The taxpayers had been living with relatives in Colorado since they were detained.

- Jurisdiction is given to district courts to issue this writ in § 7402(a).

**3. The government’s discharge from federal tax liens of real property taken by the state by eminent domain does not release its claim to damages the property owner later receives as additional compensation for the taking.** *Hannon v. City of Newton*, 744 F.3d 759 (1st Cir. 2/28/14). In addressing what it described as an issue of first impression, the First Circuit (Judge Lynch) held that the IRS’s discharge from federal tax liens (in exchange for a payment) of a parcel of real property taken by the state by eminent domain did not release any claim the IRS had on damages the former property owner later received for undercompensation. The IRS held tax liens for over \$4 million against property owned by Patrick Hannon, including a parcel of land with a residence he owned in Newton, Massachusetts. The City of Newton asked the IRS to discharge this parcel from its tax lien to facilitate the city’s taking of the property by eminent domain. The IRS did so upon receiving from the city \$57,214.55, which was an estimate of what would remain of the \$2.3 million paid by the city as compensation for the property after the mortgagee, a senior creditor, was paid. After the city took the property, Hannon brought an action in state court claiming that he had not been adequately compensated for the property. He was awarded \$420,000 in damages. The government and a lower-priority creditor intervened in the state court action and asserted priority to receive the damages. The government removed the case to federal court. The District Court granted summary judgment to the lower-priority creditor on the basis that the IRS’s discharge of the property from federal tax liens in exchange for a payment meant that the government had relinquished any claim on the subsequent damages. The First Circuit reversed and directed the District Court to enter summary judgment in favor of the government. The Court of Appeals rejected the lower-priority creditor’s argument that, “because § 6325(b)(3) sets forth a specific mechanism for maintaining liens on proceeds from the sale of discharged property, the government’s failure to use that mechanism surrendered its liens on proceeds resulting from the post-taking suit for undercompensation.” The Court of Appeals analyzed § 6325(b)(2), which

authorizes the IRS to discharge property from federal tax liens upon receiving a payment at least equal to the value of the United States' interest in the property to be discharged, and concluded that the language in the Certificate of Discharge in this case was precise and released only the parcel of land that the city was taking. It did not release, the Court of Appeals concluded, property that Hannon later acquired, including the \$420,000 in undercompensation damages. The Court of Appeals also held that, because federal law, rather than state law, controlled the attachment of federal tax liens and the scope of the IRS's discharge, the state law doctrine of equitable conversion did not remove the federal tax lien from the undercompensation damages.

**4. What part of “impartial” does the IRS not understand?** Moosally v. Commissioner, 142 T.C. No. 10 (3/27/14). The key issue in this CDP case was whether the IRS Appeals Office settlement officer to whom the taxpayer's case and hearing were assigned was an impartial officer as required by § 6320(b)(3). The facts, in brief, are that the IRS rejected the taxpayer's offer-in-compromise (OIC) for trust fund recovery penalties for two quarters in 2000, and her income tax liability for 2008. She appealed and the IRS assigned Appeals Officer Smeck to review the OIC. The IRS also had filed a Notice of Federal Tax Lien (NFTL) and issued a Letter 3172. The taxpayer requested a CDP hearing and the IRS assigned Appeals Officer Kane to conduct the CDP hearing. After Smeck had begun review of the OIC, the IRS transferred the taxpayer's CDP case from Kane to Smeck, who sustained the rejection of the taxpayer's OIC and sustained the filing of the NFTL. The taxpayer petitioned for Tax Court review of the CDP determination sustaining the NFTL, on the ground that Smeck was not impartial. The Tax Court (Judge Wells) sustained the taxpayer's appeal. Section 6320(b) requires that a CDP hearing must be conducted by an impartial officer or employee of Appeals. An impartial officer or employee is one who has had no prior involvement with respect to the unpaid tax specified in § 6320(a)(3)(A) before the first hearing under § 6320 or § 6330. The taxpayer's argument was that Smeck was not an impartial officer because Smeck had reviewed the appeal of the rejected OIC before conducting the CDP hearing for the same periods. The IRS argued that Smeck “was an impartial officer because she had not yet issued a determination and that there is no ‘prior’ involvement when a reviewing officer has not made any determination with respect to the previously rejected OIC” and that § 6320 “contemplates simultaneous review of all issues related to collections during the CDP hearing and that a simultaneous review benefits taxpayers.” Judge Wells held that Smeck was not impartial because she “had prior involvement with [the taxpayer's] unpaid tax liabilities for the periods in issue before she was assigned to handle petitioner's CDP hearing for the same taxes and periods in issue.” Smeck had reviewed the taxpayer's appeal of her rejected OIC for nearly three months before the CDP hearing was transferred

to her, and in that period had obtained and evaluated various documents, forms, and other financial information to calculate the taxpayer's reasonable collection potential and evaluate the rejected OIC. Judge Wells also rejected the IRS's argument that § 6320 "contemplates simultaneous review of all issues related to collections during the CDP hearing and that all collection matters may be handled by the same officer." Such consolidation, he held, is limited to situations involving a lien CDP hearing pursuant to § 6320 and a pre-levy CDP hearing pursuant to § 6330 regarding the same unpaid liability. Reg. § 301.6320-1(d)(1) does not allow "the combination of CDP hearings with non-CDP matters, such as the OIC rejection appeal involved in the instant case." Judge Wells also rejected the IRS's argument that the purpose of § 6320(b)(3) is limited to preventing "an Appeals officer from examining a taxpayer's underlying liability during the examination function and then handling a CDP hearing involving the same liability during the enforcement function." He concluded that § 6320(b)(3) "does not contemplate a permissive interpretation excepting all matters concerning the taxpayer's ability to pay." Accordingly, the case was remanded for a new CDP hearing before an impartial Appeals officer.

**5. The IRS takes on the Puyallup Tribe of Indians and loses: tribal per capita payments authorized after the IRS issues a notice of levy are not subject to levy.** United States v. Puyallup Tribe of Indians, 113 A.F.T.R.2d 2014-1749 (W.D. Wash. 4/9/14). The IRS issued a notice of levy to the Puyallup Tribe of Indians to collect unpaid taxes owed by a member of the tribe. Despite the levy, the tribe made distributions of tribal revenue, known as per capita payments, to the individual who owed the unpaid taxes. The government brought this action asserting a claim for the tribe's failure to honor the levy. The District Court (Judge Settle) noted that there is conflicting authority on the question whether per capita payments are "property" or "rights to property" within the meaning of § 6331, the provision that authorizes IRS levies. The court found it unnecessary to address this issue because a second issue, which it characterized as a matter of first impression, was dispositive. Under Reg. § 301.6331-1(a), "a levy extends only to property possessed and obligations which exist at the time of the levy. Obligations exist when the liability of the obligor is fixed and determinable although the right to receive payment thereof may be deferred until a later date." The court concluded that the per capita payments were not fixed and determinable because they are made at the discretion of the Tribal Council. Therefore, "a levy may attach to a tribal member's currently authorized per capita payment, but may not reach subsequently authorized per capita payments." The court granted the tribe's motion for summary judgment.

**6. The “statutory and regulatory framework does not immunize the IRS from using common sense.” The IRS failed to exercise reasonable diligence in ascertaining the taxpayer’s last known address when it sent a notice of levy to an address from which previous correspondence had been returned undelivered.** *Music v. United States*, 17 F. Supp. 3d 1327 (N.D. Ga. 4/17/14). The taxpayer was a schoolteacher who failed to file tax returns for fifteen or more years and had a history of moving without leaving a forwarding address with the Postal Service. The last tax return she filed listed her address as Summerfield, Florida. The IRS sent subsequent correspondence to her address in Georgia, which the IRS obtained from the taxpayer’s W-2 or from correspondence that the taxpayer submitted. One IRS letter sent to her Summerfield, Florida address was returned undelivered, and the IRS readdressed it to her Georgia address. After successfully corresponding with the taxpayer at her Georgia address, the IRS sent a notice of deficiency, notice and demand for payment, and notices of intent to levy, all to her Summerfield, Florida address. When the taxpayer failed to respond, the IRS issued a notice of levy to her employer in Georgia. The day after she received her levied paycheck, she quit her job. The taxpayer brought this action under § 7433, which allows a taxpayer to recover damages incurred due to the intentional, reckless, or negligent disregard of any provision of Title 26 by an IRS officer or employee in connection with collecting the taxpayer’s federal tax. The District Court (Judge O’Kelley) agreed with the taxpayer that the IRS had negligently violated § 6331(d), which requires the IRS to notify the taxpayer in writing of the intent to levy by doing one of the following at least 30 days before the levy: giving the notice in person, leaving it at the taxpayer’s dwelling or usual place of business, or sending it by certified or registered mail to the taxpayer’s last known address. The IRS violated § 6331(d), the court said, “by sending notices of intent to levy to an address when previous letters sent to that address were returned undeliverable.” However, the court characterized the taxpayer’s victory as “somewhat pyrrhic” because it concluded that “the entirety of her requested damages were not proximately caused by the IRS’ negligence and even if they were, she could have reasonably mitigated the damages.” The court allowed the taxpayer to recover costs of the action—the \$350 fee to file her complaint—and acknowledged

that its interpretation of the statute [as allowing the taxpayer to recover costs when the taxpayer has not suffered any actual, direct economic damages] conflicts with a significant number of courts that have dismissed section 7433 claims by holding

that the plaintiff did not suffer any actual, direct economic damages.

**7. You can't order the IRS to levy on particular assets—it gets to choose what to take.** Kraft v. Commissioner, 142 T.C. No. 14 (4/23/14). In review of a levy CDP proceeding, the Tax Court (Judge Wherry) held that the IRS did not abuse its discretion in deciding to collect a tax liability from the taxpayer's personal assets rather than by levying on a trust of which the taxpayer was a beneficiary. The IRS is not required to grant a taxpayer's request to collect a tax liability from a particular source.

**8. Constructive receipt of a deficiency notice for someone who played two of the three monkeys.** Onyango v. Commissioner, 142 T.C. No. 24 (6/24/14). Section 6330(c)(2)(B) allows a taxpayer to contest the underlying tax liability in a CDP hearing only if he did not actually receive a deficiency notice or otherwise have an opportunity to dispute the liability. In this case, on several occasions the Postal Service attempted unsuccessfully to deliver a deficiency notice that had been mailed to the taxpayer at his legal residence by certified mail, return receipt requested. On at least two occasions the Postal Service left notices of attempted delivery of the certified mail which contained the notice of deficiency at the address of the taxpayer's legal residence, and informed the taxpayer that it had certified mail to deliver to him and that he had to sign a receipt for that mail before the Postal Service would deliver it to him. The taxpayer declined to check on a regular basis his mailbox at his legal residence and to retrieve on a regular basis any Postal Service mail items delivered there. After several unsuccessful attempts to deliver the certified mail, the Postal Service returned it to the IRS. The Tax Court (Judge Chiechi) held that a taxpayer who is reasonably able and had multiple opportunities to check his mail and intentionally fails to do so for the purpose of avoiding receipt of the deficiency notice cannot contend that for purposes of § 6330 that he did not receive the deficiency notice. Accordingly, the taxpayer was not permitted to contest his liability in the CDP hearing.

**9. A Notice of Intent to Levy is not a levy.** Eichler v. Commissioner, 143 T.C. No. 2 (7/23/14). The taxpayer requested a partial pay installment agreement of assessed taxes. Before the request was acted upon, the IRS mailed Letters CP 90, Final Notice—Notice of Intent to Levy and Notice of Your Right to a Hearing. The taxpayer timely requested a CDP hearing, renewing his request for an installment agreement and asserting that the Letters CP 90 should be withdrawn as invalid pursuant to § 6331(k)(2), which prohibits the IRS from making a levy while an offer for an installment agreement is pending. During the CDP, hearing the settlement officer conditioned acceptance of an installment agreement on the taxpayer making

an \$8,520 down payment. The taxpayer declined to make the payment claiming economic hardship, and the settlement officer's final determination rejected the taxpayer's request that the Letters CP 90 be withdrawn as invalid and sustained the proposed levy on the ground that the taxpayer had declined the proposed installment agreement. The Tax Court (Judge Thornton) held that § 6331(k)(2) did not preclude the IRS from issuing the Letters CP 90 after the taxpayer submitted his offer for an installment agreement—§ 6331(k)(2) bars the IRS from making a levy while a taxpayer's offer for an agreement request is pending, but does not bar the IRS from issuing notices of intent to levy—and that the determination not to rescind the Letters CP 90 was not an abuse of discretion under relevant provisions of the IRM. But because the record did not allow for meaningful review of the determination regarding the appropriateness of the \$8,520 downpayment as a condition of an installment agreement, the case was remanded for further proceedings.

**10. No pre-levy remedy for you; if you're unhappy, go to District Court after the levy.** Greenoak Holdings Ltd. v. Commissioner, 143 T.C. No. 8 (9/16/14). The IRS issued a final notice of intent to levy to an estate to collect unpaid estate taxes. The estate requested a § 6330 CDP hearing. Following the hearing, the appeals officer issued a notice of determination sustaining the proposed levy as to nonprobate assets. Among the nonprobate assets reported on the estate tax return was an offshore trust that owned certain entities. The estate did not seek Tax Court review but the entities owned by the offshore trusts petitioned the Tax Court for review of the notice of determination. The IRS moved to dismiss for lack of jurisdiction. The Tax Court (Judge Ruwe) held that the "person entitled to the rights and protections under § 6330 is the taxpayer liable for unpaid Federal tax." The Tax Court lacked jurisdiction over a petition filed by a party who is neither the taxpayer nor an authorized representative of the taxpayer. The remedy for persons other than taxpayers who claim ownership rights in property subject to levy lies in the right to make a wrongful levy claim under § 7426(a)(1).

**11. The taxpayer won the initial skirmish, but lost the big battle and thus the war.** Buczek v. Commissioner, 143 T.C. No. 16 (10/6/14). The taxpayer filed a timely request for a CDP hearing in response to a final notice of intent to levy to collect an unpaid income tax liability. The request did not raise any issues specified in § 6330(c)(2) or make any allegations that reasonably indicated he was raising such an issue. The Appeals Office sent the taxpayer a letter stating that, pursuant to § 6330(g), it was disregarding the hearing request because it was frivolous and that the IRS would proceed with collection. The taxpayer filed a timely petition for review. The Tax Court (Judge Dawson) held that it had jurisdiction to review the IRS's

determination as to whether a taxpayer who sought judicial review under § 6330(d)(1) had raised an issue other than issues that had been identified by the IRS as frivolous or that reflected a desire to delay or impede the administration of Federal tax laws. However, because the taxpayer did not raise any issues specified in § 6330(c)(2) that could be considered in a CDP hearing, no portion of the taxpayer's request for a hearing was excluded from the IRS's determination to disregard the entire request and § 6330(g) prohibited further judicial review of that determination. Thus, because the determination that the IRS could proceed with collection was not made in response to a proper request for a hearing, the Tax Court lacked jurisdiction to review that determination.

### G. Innocent Spouse

There were no significant developments regarding this topic during 2014.

### H. Miscellaneous

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

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

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

Revenue Service, the FCC, and the NLRB, exercises executive power.

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

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

**2. This case is just like *Loving v. Virginia*, 388 U.S. 1 (1967), except that, instead of freeing interracial couples from discriminatory marriage laws, it is about freeing marginal tax return preparers from discriminatory competence testing.** Loving v. IRS, 917 F. Supp. 2d 67 (D.D.C. 1/18/13). The District Court (Judge Boasberg) enjoined

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

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

**a. The injunction is modified, but not stayed.**

Loving v. IRS, 920 F. Supp. 2d 108 (D.D.C. 2/1/13). On the IRS’s motion to stay the injunction, Judge Boasberg—while refusing to stay the injunction—modified it to make clear that its requirements were less burdensome than the IRS claimed. The requirement that each tax return preparer obtain a PTIN (and pay related fees) is authorized under § 6109(a)(4), so it may continue, except that the “IRS may no longer condition PTIN eligibility on being ‘authorized to practice’ under 31 U.S.C. section 330.” Therefore, “the requirements that tax return preparers (who are not attorneys, CPAs, enrolled agents, or enrolled actuaries) must pay fees unrelated to the PTIN, pass a qualifying exam, and complete annual continuing-education requirements” continue to be enjoined.

**b. Government’s motion for a stay pending appeal was denied summarily.** Loving v. IRS, 111 A.F.T.R.2d 2013-1384 (D.C. Cir. 3/27/13) (Rogers, Tatel, and Brown, JJ, per curiam) (unpublished). The IRS appealed these two opinions and orders to the Circuit Court for the District of Columbia Circuit, 2/20/13. That court refused to stay the District Court’s injunction on the ground that the IRS failed to satisfy “the stringent requirements for a stay pending appeal.”

**c. The D.C. Circuit found that registered (?) tax return preparers were entitled to be unqualified. The IRS had the gall to require character, competence, and continuing education for “independent” tax return preparers who only needed PTINs to continue preparing error-laden tax returns for their unsophisticated clientele.** Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2/11/14), *aff’g* 920 F. Supp. 2d 108

(D.D.C. 2/1/13). The D.C. Circuit (Judge Kavanaugh) held that regulations issued in 2011 under 31 U.S.C. § 330 that imposed new character, competence, and continuing education requirements on tax return preparers were “foreclose[d] and render[ed] unreasonable” by the statute, and thus failed at the *Chevron* step one standard. They would have also failed at the *Chevron* step two standard because they were “unreasonable in light of the statute’s text, history, structure, and context.”

- Judge Kavanaugh’s opinion found six problems with the 2011 regulations: (1) tax return preparers were not “representatives” because they are not “agents” and, thus, lack “legal authority to act on the taxpayer’s behalf”; (2) the preparation and filing of a tax return did not constitute “practice . . . before the Department of the Treasury” because that term implies “an investigation, adversarial hearing, or other adjudicative proceeding”; (3) the history of the statutory language originally enacted in 1884 “indicated that the statute contemplated representation in a contested proceeding”; (4) the regulation was inconsistent with the “broader statutory framework,” (!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the IRS had authority to regulate tax-return preparers; (5) the statute would have been clearer had it granted power “for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry” (“the enacting Congress did not intend to grow such a large elephant in such a small mousehole”); and (6) the IRS’s past approach showed that until 2011 it never maintained that it had authority to regulate tax return preparers.

- Judge Kavanaugh concluded: “The IRS may not unilaterally expand its authority through such an expansive, atextual, and ahistorical reading of Section 330.”

- It appears that the DOJ did not seek en banc review.

**d. Does this mean that all tax return preparers can now charge contingent fees for tax return preparation, e.g., a percentage of the tax refund?** *Ridgely v. Lew*, 114 A.F.T.R.2d 2014-5249 (D.D.C. 7/16/14). A practicing CPA brought suit to challenge Circular 230, § 10.27, which prohibited tax practitioners from charging contingent fees for certain services relating to preparing or filing tax returns or refund claims. He argued that the IRS exceeded the scope of its statutory authority in regulating the preparation of “Ordinary Refund Claims,” i.e., refund claims that practitioners file after a taxpayer has filed his original tax return but before the IRS has initiated an audit of the return. On motion for summary judgment, District Judge Cooper granted the CPA’s motion and enjoined the IRS from

enforcing § 10.27. He noted that “[t]his Court, however, is not the first to venture down this particular rabbit hole,” and that *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), “is controlling precedent that must guide [his] examination of [31 U.S.C. § 330’s] text, context, and history with respect to the claims at issue . . . .” He rejected the IRS’s argument that it has the power to regulate plaintiff’s practice as a CPA before it, because that power does not extend regulation of those of his activities which do not constitute practice, i.e., preparation and filing of refund claims.

**e. There is life after suspension for CPAs to prepare tax returns.** “Some Suspended or Disbarred Tax Practitioners Are Now Permitted To Obtain PTINs and Prepare Tax Returns,” IRS announcement dated 8/26/14, found at [www.irs.gov/Tax-Professionals/Tax-Pro-News-and-Events](http://www.irs.gov/Tax-Professionals/Tax-Pro-News-and-Events) (last viewed 9/13/14). This announcement is based on *Loving v. IRS*, which held that tax return preparation, without more, does not constitute representation within the meaning of 31 U.S.C. § 330, and the IRS may not include a restriction on return preparation for compensation. It applies to individuals who were suspended or disbarred, with PTIN access blocked between 8/2/11 and 2/11/14; individuals sanctioned before or after these dates did not have their PTIN access blocked.

• Circular 230, § 10.24 provides with respect to disbarred or suspended persons:

§ 10.24 Assistance from or to disbarred or suspended persons and former Internal Revenue Service employees.

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

**3. In light of the IRS loss in *Loving v. IRS*, a new, voluntary Annual Filing Season Program to give tax return preparers the ability to claim they hold “a valid Annual Filing Season Program Record of Completion”** and that they have “complied with the IRS requirements for receiving the Record of Completion.” Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14). In order to encourage unenrolled tax return preparers, i.e., those who are not attorneys, CPAs or EAs, to complete continuing education courses in order to get a better understanding of federal tax law, the carrot of being able to claim superiority to the ordinary run-of-the-mill slob tax return preparers is offered. The requirements for this voluntary program include a six-hour refresher course, with a 100-question test at the end, plus other continuing education of two hours of ethics and ten hours of federal tax law topics.

Holders of the Record of Completion may not use the terms “certified,” “enrolled,” or “licensed” to describe the designation.

**4. Not having access to a cooperating witness’s returns does not violate the defendant’s Sixth Amendment right to confront witnesses in a prosecution for preparing and filing false tax returns.** United States v. Love, 553 F. App’x 548 (6th Cir. 1/29/14). The defendant worked as a tax return preparer at an H&R Block branch located in a Wal-Mart in Toledo, Ohio. A jury found her guilty on one count of conspiring to prepare false tax returns and fifty-nine counts of aiding the preparation and filing of false tax returns. According to the evidence at trial, the defendant prepared false returns that resulted in refunds for people referred to her by her cousin, Sonya Moses. Moses cooperated with the government in the defendant’s prosecution. The defendant argued on appeal that not having access to Moses’s tax returns violated her Sixth Amendment right to confront the witnesses against her because the returns would have aided in her cross-examination of Moses. In an opinion by Judge Donald, the Sixth Circuit rejected the defendant’s argument and concluded that the district court did not abuse its discretion or impermissibly impede the defendant’s right to confront and cross-examine Moses. The court also rejected her argument that the government did not present sufficient evidence to prove beyond a reasonable doubt that she knew that the incomes reported in the returns of certain persons were false.

**5. Whistleblowers’ motions to proceed anonymously to obtain judicial review of awards were granted in light of risk of severe physical harm if their identities were to be revealed.** Whistleblower 11332-13W v. Commissioner, T.C. Memo. 2014-92 (5/20/14); Whistleblower 10949-13W v. Commissioner, T.C. Memo. 2014-94 (5/20/14). In these two cases, the Tax Court (Judge Kroupa) granted motions to seal and proceed anonymously by two whistleblowers, each of whom had been intimidated with physical force and armed men on behalf of their employer and related entities (“targets”)—which paid more than \$30 million in taxes, penalties, and interest. The Commissioner did not object to these motions and the targets did not participate in these proceedings. Judge Kroupa stated that the general presumption of openness of judicial proceedings was outweighed by the “demonstrated risk of physical harm to [the whistleblower] or [the whistleblower’s] family.” The motions were based upon a recently-adopted Tax Court Rule 345, which created a mechanism to preserve the anonymity of whistleblowers and non-party taxpayers.

- It seems that these two whistleblowers worked for the same employer, although the opinions did not so state. Reading

between the lines of these opinions, it appears that the targets were well aware of the identities of the whistleblowers. In light of this, what was gained by granting anonymity? One possibility is that sealing the cases did protect the identities of the lawyers involved.

**a. Whistleblower's motion to proceed anonymously was granted in light of whistleblower being retired and receiving retirement benefits from his former employer.** Whistleblower 13412-12W v. Commissioner, T.C. Memo. 2014-93 (5/20/14). The Tax Court (Judge Kroupa) granted whistleblower's motion to proceed anonymously seeking review of Commissioner's determination and to have the record sealed. The whistleblower reported the nature of tax violations by his former employer and provided legal analysis and reasoning for Commissioner to proceed against the target, but Commissioner "issued the whistleblower a letter indicating that he was unable to collect any amounts on the whistleblower's claim." The whistleblower is retired and receives retirement benefits from his former employer, the target. While no threat of physical harm was alleged, the whistleblower alleged the possibility of "suffer[ing] professional ostracism, harm and job-related harassment because other potential employers will unlikely want to hire or employ a known whistleblower." Judge Kroupa decided to "err on the side of caution" despite her belief "that distributions from an employer's retirement plans are governed by the plan's provisions and an independent trustee that has fiduciary obligations."

**b. Tax Court has jurisdiction to review a whistleblower claim and award determination where the claim is based on information provided both before and after 12/20/06, which was the effective date of § 7623(b).** Whistleblower 11332-13W v. Commissioner, 142 T.C. No. 21 (6/4/14). The Tax Court (Judge Kroupa) decided that it had jurisdiction to review a whistleblower claim award determination where the claim was based on information provided both before and after the 12/20/06 effective date of § 7623, which was added by the Tax Relief and Health Care Act of 2006.

- To the same effect is Whistleblower 10949-13W v. Commissioner, T.C. Memo. 2014-106 (6/4/14), also decided by Judge Kroupa.

**6. The IRS didn't get to collect a concededly duplicate refund because it took a wrong turn at the fork in the road.** YRC Regional Transport, Inc. v. Commissioner, T.C. Memo. 2014-112 (6/10/14). The IRS issued a duplicate refund to the taxpayer through a clerical error and attempted to recover it through a deficiency proceeding. The Tax Court (Judge

Kerrigan) held that the IRS could not recover the refund—a nonrebate refund—pursuant to a deficiency procedure because there had been no redetermination of the taxpayer’s tax liability. The government could recover the erroneous refund only pursuant to suit under § 7405 or under any available administrative collection procedures.

**7. Those proposed Circular 230 regulations are now final, so you can—but need not—remove those mindless disclaimers from your emails. But if they remain, they cannot refer to the IRS or Circular 230.** T.D. 9668, Regulations Governing Practice Before the Internal Revenue Service, 79 F.R. 33685 (6/12/14). The final Circular 230 regulations include the following:

- The rigid covered opinion rules in former § 10.35 (which required that the written opinion contain a description of the relevant facts, the application of the law to those facts, and the practitioner’s conclusion with respect to the law and the facts) are removed; these rules are replaced with a single standard for all written tax advice under final § 10.37. This standard requires that the practitioner must: (i) base the written advice on reasonable factual and legal assumptions; (ii) reasonably consider all the relevant facts that the practitioner knows or “*reasonably should know*” (emphasis added); (iii) use reasonable efforts to identify and ascertain the facts relevant on each Federal tax matter; (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable; (v) “*[r]elate applicable law and authorities to facts*” (emphasis added); and (vi) not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. The determination of whether a practitioner has failed to comply with these requirements is based on all the facts and circumstances, not on whether each requirement is addressed in the written advice. Note: Material new in the final regulations is in boldface. The preamble makes clear that practitioners may consider the “the existence or nonexistence of legitimate hazards that may make settlement more or less likely.”

- As to disclaimers, the preamble states that “Treasury and the IRS expect that these amendments will eliminate the use of a Circular 230 disclaimer in e-mail and other writings,” but they “do not, however, prohibit the use of an appropriate statement describing any reasonable and accurate limitations of the advice rendered to the client.” While continuing education presentations are not considered written advice on a Federal tax matter for purposes of § 10.37, “Treasury and the IRS nonetheless expect that practitioners will follow the generally applicable diligence and competence standards under §§ 10.22 and 10.35 when engaged in those activities.” The authors of this outline, therefore, use the following statement to describe the

limitations with respect to any of the information contained in the outline, “Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right.”

- Final § 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS (including providing written opinions), which includes the required knowledge, skill, thoroughness, and preparation necessary for the matter for which he is engaged. This complements the provision in § 10.51 that a practitioner can be sanctioned for incompetent conduct.

- Final § 10.36 conforms the “procedures to ensure compliance” with the removal of the covered opinion rules in former § 10.35, but expands these “procedures to ensure compliance” to include the provisions of subparts A, B, and C of Circular 230.

- Final § 10.1 provides that the Office of Professional Responsibility—as opposed to the IRS Return Preparer Office—will have exclusive responsibility for matters related to practitioner discipline.

- Final § 10.82 extends the expedited disciplinary procedures for immediate suspension, but limits it to practitioners who have engaged in a pattern of willful disreputable conduct by failing to make an annual Federal tax return during four of five tax years immediately before the institution of the expedited suspension proceeding, provided that the practitioner is also noncompliant at the time the notice of suspension is served.

- Final § 10.31 forbids practitioners from negotiating any taxpayer refunds, which specifically adds manipulation of any electronic refund process.

- The effective date of the provisions added or amended by the final regulations is 6/12/14.

**8. “Final” means “final”; mulligans not allowed.** *Snow v. Commissioner*, 142 T.C. No. 23 (6/17/14). In an earlier decision, T.C. Memo. 1996-457, the Tax Court held that deficiency notices mailed to the taxpayer were valid. The 1996 final order reached the opposite result from the Special Trial Judge’s initial report, which would have held the deficiency notices were invalid. The taxpayer filed a motion to vacate the original decision, apparently relying on *Ballard v. Commissioner*, 544 U.S. 40 (2005), and the resulting revisions to Tax Court Rule 183, which require that the initial report of the Special Trial Judge be provided to the parties and allow them to submit written objections before the report is reviewed by a regular Judge. The Tax Court (Judge Ruwe) denied the motion, which was filed almost eight years after taxpayer first learned of the Special Trial Judge’s initial report and over 16 years after the decision had become final. Generally, once a Tax Court

decision becomes final, the court lacks jurisdiction to vacate that decision. There are three possible exceptions: (1) when the Tax Court may have originally lacked jurisdiction to enter a final decision; (2) when there is a fraud upon the court; and (3) mutual mistake, where the Tax Court decision was predicated on the parties' stipulation, and both the government and the taxpayer concede they mistakenly entered into the stipulation. None of them were present in this case.

**9. “Where a statute is capable of various interpretations, we are inclined to adopt a construction which will permit the Court to retain jurisdiction without doing violence to the statutory language.”** *Comparini v. Commissioner*, 143 T.C. No. 14 (10/2/14). The petitioners filed a claim for a whistleblower award under § 7623(b). In 2012, the Whistleblower Office sent four essentially identical letters to the petitioners stating that they were not eligible for an award and inviting them to contact the Whistleblower Office with any questions. Subsequently, the petitioners submitted additional information in support of their claim. In 2013, the Whistleblower Office sent the petitioners a letter stating that it had “determined your claim still does not meet our criteria for an award,” “[o]ur determination remains the same,” and “we are closing this claim.” The petitioners filed a petition for Tax Court review under § 7623(b)(4) within 30 days after receiving the 2013 letter. The IRS moved to dismiss on the ground that the petition filed in response to the 2013 letter was untimely because it had not been filed within 30 days after the determination in the 2012 letters. In a reviewed opinion by Judge Colvin (in which eight judges joined and with a number of concurring opinions), the Tax Court held that the 2013 letter constituted a determination for purposes of § 7623(b)(4) and denied the IRS's motion to dismiss for lack of jurisdiction. The 2013 letter from the Whistleblower Office was a “determination regarding an award” within the meaning of § 7623(b)(4) and because the petitioners filed a petition within 30 days of that letter, the court had jurisdiction. “[T]he 2013 letter constitutes a determination and . . . its status as a determination is not negated . . . by the fact that the Whistleblower Office sent the 2012 letters.” It is “possible for the Whistleblower Office to issue, as to a given claim, more than one ‘determination’ on which [Tax Court] jurisdiction might be based.”

- A joint concurring opinion by Judges Halpern and Lauber (in which four other judges joined) agreed that the Whistleblower Office “can make more than one ‘determination’ with respect to a claimant's claim or universe of claims.” But the concurring opinion would have expressly limited the holding to cases where the subsequent claim differs from the earlier claim; “if the claim is not different and the determination is the same,

and if the petition is filed more than 30 days after the original determination, the Court should hold that it lacks jurisdiction . . . .”

**10. Once Tax Court jurisdiction is properly invoked, the IRS can't undo it by saying “sorry, we sent the letter by mistake.”** Ringo v. Commissioner, 143 T.C. No. 15 (10/6/14). The petitioner filed a claim for a whistleblower award under § 7623(b). On November 7, 2012, the Whistleblower Office mailed to him a letter stating that he was ineligible for an award because he had not provided the IRS with information that resulted in the collection of any tax from the target. The petitioners filed a timely petition for Tax Court review under § 7623(b)(4). On June 11, 2013, the Whistleblower Office notified the petitioner that it was still considering the application and that it had mailed the November 7, 2012, letter in error. The IRS then moved to dismiss the case for lack of jurisdiction. The Tax Court (Judge Colvin) held that the November 7, 2012, letter was a determination and that the Tax Court had jurisdiction with respect to the matter. Furthermore, the fact that the IRS continued to consider the petitioner's claim after sending the November 7, 2012, letter did not terminate the Tax Court's jurisdiction.

**11. Bad guys finish last.** Rader v. Commissioner, 143 T.C. No. 19 (10/29/14). The taxpayer worked and earned income but failed to file returns for several years. The IRS prepared substitute returns for those years and issued deficiency notices. The Tax Court (Judge Halpern) rejected the taxpayer's argument that the substitute returns were not valid because they did not include a Form 1040. Furthermore, the IRS had the right to elect to treat the taxpayer as married filing separately in properly filed amendments to its answer, which resulted in increased deficiencies. The court sustained the deficiencies determined by the IRS. The court also rejected the taxpayer's claim that he was entitled to an offset against the deficiency for one year equal to the amounts withheld under § 1445 from the proceeds from two real estate sales in that year. Although § 1445 applies to payments made to foreign persons for the disposition of U.S. real property, and the taxpayer was a U.S. citizen, the withholding resulted from the taxpayer's failure to provide a tax identification number to the escrow agent. The improper withholding did not give rise to a § 31 credit (wage withholding), but rather to a credit under § 33 (withholding on nonresident aliens), and under § 6211(b)(1), a § 33 credit expressly is disregarded for purposes of computing a deficiency. The court also held that the taxpayer's wife was not entitled to a refund of the overpayment because a refund claim would not have been timely. Penalties for failure to timely file returns, failure to pay taxes shown on the return, and failure to pay estimated taxes were upheld. On its own motion, the court imposed a \$10,000 frivolous argument penalty under § 6673 because of the taxpayer's groundless arguments and unwarranted attempt to assert his Fifth

Amendment privilege (“In order for an individual to validly claim the privilege against self-incrimination, there must be a ‘real and appreciable danger’ from ‘substantial hazards of self incrimination,’ and the individual must have ‘reasonable cause to apprehend (such) danger from a direct answer to questions posed to him.’”), finding that he acted with the intent to delay collection of the taxes owed.

**12. The whistleblower won the first skirmish but is likely to be left whistling in the dark when the battle’s over.** Lippolis v. Commissioner, 143 T.C. No. 20 (11/20/14). A whistleblower sought Tax Court review of a § 7623(a) 15 percent discretionary award with respect to \$844,746 of tax collected as a result of an audit performed in response to his whistleblower claim. He argued that he was entitled to a greater (mandatory) award under § 7623(b). The IRS moved to dismiss for lack of jurisdiction on the ground that § 7623(b)(5)(B) provides that a mandatory award is not required unless the tax, penalties, and interest involved in the underlying audit exceeded \$2 million. The Tax Court (Judge Colvin) held that the \$2 million requirement is an affirmative defense and is not jurisdictional. Accordingly, the IRS’s motion was denied. But the IRS was given 60 days to file a motion for leave to amend the answer to raise the § 7623(b)(5)(B) affirmative defense and to include allegations of fact supporting the amendment to the answer.

**13. The Tenth Circuit stirs the previously muddled water on whether a late-filed return is a “return” that will permit tax debt to be discharged in bankruptcy proceedings.** In re Mallo, 114 A.F.T.R.2d 2014-7022 (10th Cir. 12/29/14). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a “return” within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers’ federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

(B) with respect to which a return, or equivalent report or notice, if required—

(i) was not filed or given; or

(ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

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

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

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a “return” for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a “return” because it does not satisfy “the requirements of applicable nonbankruptcy law (including applicable filing requirements)” within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a “return” within the meaning of 11 U.S.C. § 523(a).

- The Tenth Circuit’s interpretation of 11 U.S.C. § 523(a) is contrary to the IRS’s interpretation, which the IRS made clear to the court during the appeal. The IRS’s interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that “section 523(a) does not provide that every tax for which a return was filed late is nondischargeable.” However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) “is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not ‘filed’ within the meaning of section 523(a)(1)(B)(i).”

## XI. WITHHOLDING AND EXCISE TAXES

### A. Employment Taxes

**1. The story line is just a rerun: NOLs do not reduce self-employment income.** DeCrescenzo v. Commissioner, T.C. Memo. 2012-51 (2/27/12). The taxpayer was assessed deficiencies when he failed to file a return of income from self-employment as an accountant. The Tax Court (Judge Marvel) held—yet again—that § 1402(a)(4) prohibits a taxpayer from offsetting net earnings from self-employment with an NOL carryforward or carryback.

**a. And the Second Circuit sees it the same way.** DeCrescenzo v. Commissioner, 563 F. App'x 858 (2d Cir. 4/30/14). In a summary order, the Second Circuit affirmed and held that § 1402(a)(4) “expressly excludes net operating loss carryovers from the calculation of self-employment income.”

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

be excluded from employment taxes, SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit's holding in *CSX Corp.*, which adopted the eight part test of Rev. Rul. 90-72, stating that: "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories." The court also stated that it could not conclude that the opinion in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), eroded the holding of *Rowan Cos. v. United States*, which compelled the court to interpret the meaning of "wages" the same for withholding and employment tax purposes.

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

- The Court expressly did not address the

question of whether the IRS's position, expressed in rulings such as Rev. Rul. 90-72, 1990-2 C.B. 211, that severance payments tied to the receipt of state unemployment benefits are exempt from both income tax withholding and FICA taxation, is consistent with the broad definition of wages under FICA.

**3. Final regulations define employment tax liabilities of payors designated by an employer to pay employment taxes.** T.D. 9662, Designation of Payor to Perform Acts Required of an Employer, 79 F.R. 17860 (3/31/14). The Treasury and IRS have finalized, with minor changes, proposed amendments to regulations under § 3504 (REG-102966-10, Designation of Payor as Agent to Perform Acts Required of an Employer, 78 F.R. 6056 (1/29/13)). The final regulations provide that a person that pays wages or compensation to individuals who perform services for an employer pursuant to a service agreement “is designated [under § 3504] to perform the acts required of an employer with respect to the wages or compensation paid.” The regulations refer to the employer under a service agreement as the “client.” The payor and the employer both are subject to all provisions of law, including penalties, that apply to employers. The preamble to the proposed regulations indicated that consistent with the IRS position on administering the § 6672 trust fund penalty, the employment tax liability of an employer will be collected only once whether from the payor or the employer. A service agreement is an agreement pursuant to which the payor (1) asserts explicitly or implicitly that it is the employer of the individuals performing services for the client, (2) pays wages or compensation to the individuals for services they perform for the client, and (3) assumes responsibility to collect, report, and pay employment taxes with respect to the wages or compensation paid. A payor is not considered designated to perform the acts required of an employer under the regulations if the payor (1) reports employment taxes under the client's EIN, (2) is a common paymaster under §§ 3121(s) or 3231(i), (3) is itself the employer of a person performing services for a client (including both a common law employer and a statutory employer who has legal control over the payment of wages under § 3401(d)(1)), or (4) is treated as an employer under § 3121(a)(2)(A), which addresses, among other things, payments for sickness or accident disability. Like the proposed regulations, the final regulations contain several examples to illustrate their application. The “final regulations are effective for wages or compensation paid by a payor in quarters beginning on or after March 31, 2014.”

**4. The IRS's failure to send a determination by certified or registered mail gives the taxpayer an extended period of time to file for Tax Court review of worker classification.** SECC Corp. v. Commissioner, 142 T.C. No. 12 (4/3/14). The taxpayer filed a petition under

§ 7436 seeking a determination of the proper classification of its workers for employment tax purposes. On April 15, 2011, the IRS mailed to the taxpayer a letter stating that the taxpayer's employment tax liabilities as determined by Appeals would be assessed. The letter was not sent by certified or registered mail. The taxpayer's petition was filed more than 90 days after the IRS sent the April 15, 2011, letter. The Tax Court (Judge Colvin) held that the Tax Court had jurisdiction and the petition was timely. He reasoned as follows. First, the April 15, 2011 letter was a determination by the IRS relating to the classification of workers for employment tax purposes. Thus, the Tax Court had jurisdiction. Second, because the IRS did not send the determination by certified or registered mail, the 90-day period for filing an action in the Tax Court provided in § 7436(b)(2) was inapplicable; the petition was timely. Both the IRS's and taxpayer's motions to dismiss for lack of jurisdiction were denied.

**5. Bankrupt employer? Little chance the promised retirement benefits will be paid? It doesn't matter. This United Airlines pilot still owed FICA taxes on the present value of future retirement benefits he will never receive.** *Balestra v. United States*, 113 A.F.T.R.2d 2014-2301 (Fed. Cl. 5/31/14). In 2004, the taxpayer retired from his position as a pilot with United Airlines and, pursuant to § 3121(v)(2), the present value of his future retirement benefits (\$289,601) was included in his FICA base for the year of his retirement. Section 3121(v)(2) provides that amounts deferred under a nonqualified deferred compensation plan must be taken into account for FICA purposes as of the later of the time the services are performed or the time when there is no substantial risk of forfeiture of the right to such amounts. United Airlines entered bankruptcy proceedings in 2002 and its liability for the taxpayer's retirement benefits was ultimately discharged. The taxpayer received only \$63,032 of the promised benefits. The taxpayer brought this action seeking a refund of the FICA taxes he paid (at the 1.45% rate for the Medicare portion of FICA) on the \$226,569 of retirement benefits that he never received. The regulations issued under § 3121(v)(2), Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), prescribe the method of determining present value and provide that the present value of future retirement benefits

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

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

**6. Disregarded entities are regarded for employment tax purposes, except when they are disregarded.** T.D. 9670, Disregarded Entities; Religious and Family Member FICA and FUTA Exceptions; Indoor Tanning Services Excise Tax, 79 F.R. 36204 (6/26/14). The Treasury has finalized, without substantive change, temporary and proposed regulations issued in 2011 that extend the exemptions from FICA and FUTA taxes for members of certain religious faiths and for certain services performed for family members to services performed in the employ of disregarded entities. Several cases, sustaining the check-the-box regulations under *Chevron* deference, held that the sole owner of a disregarded entity was liable for the disregarded entity's employment taxes. See, e.g., *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007); *McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007). In the face of these litigation successes, the Treasury adopted Reg. § 301.7701-2(c)(2)(iv) to provide that a disregarded entity is treated as a corporation for employment tax purposes and related reporting requirements, thereby shifting the liability away from the owner. However, treating the entity as a corporate employer would eviscerate provisions that exempt certain employment among family members and employment among religious persons who believe that Social Security taxes are contrary to the teachings of the religion or sect. Thus, the final regulations, Regs. §§ 31.3121(b)(3)-1(d) and 31.3306(c)(5)-1(d), provide that a disregarded entity treated as a corporation for employment tax purposes will not be treated as the employer for purposes of §§ 3121(b)(3) and 3306(c)(5), which provide an exemption from employment taxes for certain services performed by and for parents, children, and spouses. Final regulation § 31.3127-1(b) provides that a disregarded entity will not be treated as the employer for purposes of § 3127, which provides an exception from FICA taxes where both the employer and employee are members of a religion that opposes participation in Social Security. Under each of these provisions, for purposes of applying the exemptions only, the owner of the disregarded entity will be treated as the employer. Further, final regulation § 301.7701-2T(c)(2)(iv)(C)(1) provides

that the owner of a disregarded entity remains subject to the backup withholding requirements of § 3406. The changes are effective for wages paid after 11/1/11, but taxpayers may apply the rules to wages paid on or after 1/1/09.

## B. Self-Employment Taxes

1. According to the Tax Court, “The self-employment tax provisions are construed broadly in favor of treating income as earnings from self-employment.” **Old McDonald had a farm and on his farm he collected federal subsidies that were self-employment income.** Morehouse v. Commissioner, 140 T.C. No. 350 (6/18/13). In a reviewed opinion (15-0-0), the Tax Court (Judge Marvel) overruled its prior decision in Wuebker v. Commissioner, 110 T.C. 431 (1998), *rev’d*, 205 F.3d 897 (6th Cir. 2000), and held that payments under the U.S. Department of Agriculture (USDA) Conservation Reserve Program (CRP) are self-employment income subject to self-employment taxes. The taxpayer owned farm land in South Dakota, which he had rented to tenant farmers. The taxpayer entered into a CRP contract with the USDA under which in exchange for annual payments, the taxpayer agreed to (1) maintain already established grass and legume cover for the life of the contract; (2) “[e]stablish perennial vegetative cover on land temporarily removed from agricultural production,” including pubescent or intermediate wheatgrass, alfalfa, and sweet clover; and (3) engage in “pest control and pesticide management” for the life of the contract. The taxpayer hired a former tenant farmer to carry out most of the work, but the taxpayer supervised the operation, purchased materials needed to implement the conservation plans, gathered documentation necessary to the CRP payments, arranged for individuals to hunt on some of the properties, and visited the properties several times during the tax years involved. The court held that these activities were sufficient to constitute a trade or business carried on by the taxpayer the income from which was subject to self-employment taxes under § 1402(a)(1). The court indicated that regardless of whether the taxpayer’s activities qualified as farming, the taxpayer was directly and through his agent “engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit.”

a. But according to the Eighth Circuit, “we embrace the agency’s longstanding position that land conservation payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax.” Morehouse v. Commissioner, 769 F.3d 616 (8th Cir. 10/10/14). In an opinion by Judge Beam (2-1), the Eighth Circuit reversed the Tax Court’s decision and held that “land conservation

payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax.” The court relied on Rev. Rul. 60-32, 1960-1 C.B. 23, in which the IRS concluded that soil bank payments made to persons who did not operate or materially participate in a farming operation were “not to be included in determining net earnings from self-employment,” although soil bank payments to farmers were to be treated as self-employment income derived from their farming business. The court noted that “[a]lthough Revenue Ruling 60-32 did not explain why the IRS differentiated between farmers and non-farmers, [Rev. Rul. 65-149, 1965-1 C.B. 434] indicated the IRS viewed soil bank payments to non-farmers as rental income.” The court accorded no deference to the proposed revenue ruling in Notice 2006-108, and it distinguished *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000), *rev’g* 110 T.C. 431 (1998), as “seem[ing] to rest on its conclusion that, because the taxpayers’ maintenance obligations under their CRP contracts were intrinsically similar to activities performed in their active farming operation—‘tilling, seeding, fertilizing, and weed control’—these obligations did not rise to the level of ‘occupancy or use’ by the government.”

While CRP contracts may require farmers to conduct a small subset of activities similar to those used in a portion of their general farming operations, *Wuebker*, 205 F.3d at 903, the same cannot be said for non-farmers. The only reason they even indirectly engage in or arrange for any “tilling, seeding, fertilizing, and weed control” activities on their CRP land is because the agreement with the government requires them to do so. *Id.*

• Judge Gruender dissented. Even if he gave no deference to Notice 2006-108—particularly in light of the IRS’s inconsistent positions—he agreed with its interpretation of the rentals-from-real-estate exclusion.

[E]ven according no deference to Notice 2006-108, I agree with its interpretation of the rentals-from-real-estate exclusion. Because the term “rentals from real estate” is not defined in the Internal Revenue Code, it must be interpreted “in accordance with its ordinary or normal meaning,” . . . with the qualification that, as an exclusion from net earnings from self-employment, the rentals-from-real-estate exclusion must be narrowly construed.

The CRP payments were not “rent,” because “Morehouse enjoyed uninterrupted and unfettered access to his property. Under these circumstances, it cannot be said that Morehouse’s checklist of tasks along with the government’s sporadic

entries onto his property somehow translated into ‘use’ of Morehouse’s property by the government.”

### C. Excise Taxes

**1. Telephone excise tax trouble for the government ahead.** *Cohen v. United States*, 578 F.3d 1 (D.C. Cir. 8/7/09) (2-1). In this telephone excise case, Judge Janice Rogers Brown’s majority opinion held that the telephone excise tax challenge litigation violated neither (1) the Anti-Injunction Act, 26 U.S.C. § 7421(a), which provides that “no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed” nor (2) the Declaratory Judgment Act, 28 U.S.C. § 2201(a), which allows for declaratory relief but specifically excludes federal taxes from its reach, because (a) the standalone Administrative Procedure Act, 5 U.S.C. § 702, claim in the instant case is “the anomalous case where the wrongful assessment is not disputed and the litigants do not seek a refund,” and (b) the Declaratory Judgment Act is coextensive with the Anti-Injunction Act (citing circuit precedent). Judge Brown began her opinion:

Comic-strip writer Bob Thaves [creator of *Frank and Ernest* (1972)] famously quipped, “A fool and his money are soon parted. It takes creative tax laws for the rest.” In this case it took the Internal Revenue Service’s (“IRS” or “the Service”) aggressive interpretation of the tax code to part millions of Americans with billions of dollars in excise tax collections. Even this remarkable feat did not end the IRS’s creativity. When it finally conceded defeat on the legal front, the IRS got really inventive and developed a refund scheme under which almost half the funds remained unclaimed. Now the IRS seeks to avoid judicial review by insisting the notice [Notice 2006-50] it issued, acknowledging its error and announcing the refund process, is not a binding rule but only a general policy statement.

- Judge Brown stated that the IRS position was “just mean,” and that it “places taxpayers in a virtual house of mirrors.” She continued, “Despite the obvious infirmities of [the IRS position], the IRS still has

the chutzpah to chide taxpayers for failing to intuit that neither the agency's express instructions nor the warning on its forms should be taken seriously."

- Judge Brown concluded, however, that "[a]ppellant Neiland Cohen filed his refund claim prematurely and, [we] thus, affirm the District Court's dismissal of his refund claim." The case was remanded to the District Court for its consideration of the merits.

- Judge Kavanaugh dissented, stating that the appellant could simply have followed the procedures of Notice 2006-50.

- The D.C. Circuit granted rehearing en banc, 3/11/10.

**a. A case warning that tax professionals continue to ignore administrative law at their (clients'(?)) peril.** The panel holding was upheld on rehearing en banc. Cohen v. United States, 650 F.3d 717 (D.C. Cir. 7/1/11) (6-3). In upholding its original panel decision to remand the case to the District Court for its consideration of the merits, Judge Brown wrote the majority opinion that held the suit was not precluded by either the Anti-Injunction Act or the Declaratory Judgment Act. Judge Kavanaugh's dissent emphasized that this suit was merely a prelude to a class action suit seeking monetary relief from the government, and that there was an adequate remedy in individual refund suits following claims for refund under the procedures of Notice 2006-50 in which all claims under the Administrative Procedure Act could be asserted.

- **"Enough, already!" The IRS cries, "Uncle."** Notice 2006-50, 2006-1 C.B. 1141 (5/26/06), *revoking* Notice 2005-79, 2005-2 C.B. 952. The IRS announced that it will stop assessing the § 4251 telephone excise tax on long distance services, and that it will provide for refunds of taxes paid on services billed after 2/28/03 and before 8/1/06. These refunds are to be requested on 2006 Federal income tax returns, the right to which will be preserved by the IRS scheduling overassessments under § 6407. Individuals are eligible to receive a safe harbor amount, which has not yet been determined. Interest received on the refunds will have to be reported as 2007 income.

**b. On remand, the district court granted prospective vacatur of Notice 2006-50.** In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 853 F. Supp. 2d 138 (D. D.C. 4/10/12). The District Court (Judge Urbina) found Notice 2006-50 to have been improperly promulgated in violation of the Administrative Procedure Act, i.e., that it was a binding rule promulgated without notice and hearing. However, he dismissed two of the three complaints [Cohen and Gurrola plaintiffs] consolidated for pre-trial proceedings that failed to raise that ground, and permitted only one complaint [Sloan plaintiffs] to go forward.

Judge Urbina granted relief on that third complaint by merely vacating that notice prospectively, i.e., he issued a prospective vacatur.

**c. The district court entered final judgment.**

In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 901 F. Supp. 2d 1 (D.D.C. 10/29/12). The District Court (Chief Judge Lamberth, following Judge Urbina's retirement) entered final judgment in favor of the Sloan plaintiffs on their procedural APA claim and in favor of the government on all other claims of the three plaintiffs.

**d. In its divided panel decision following remand, the D.C. Circuit upheld the district court decision anticipatorily vacating Notice 2006-50, but approved of the IRS's failure to offer any further relief. Judge Brown dissented in a vehement opinion blasting the IRS and the horse it rode in on.** In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 751 F.3d 629 (D.C. Cir. 5/9/14), *petition for rehearing en banc denied*, 2014 U.S. App. LEXIS 12636 (7/2/14), *cert. denied*, 2015 WL 133496 (1/12/15). The D.C. Circuit (Judge Randolph) affirmed the district court judgment, holding that the remand order to the IRS to permit it to correct mistakes in the issuance of Notice 2006-50 was an appealable decision.

• Judge Janice Rogers Brown dissented, stating:

This is a complicated and frustrating case. It has lasted five years and accomplished nothing. In this litigation, the Internal Revenue Service (IRS) has lost every round, but, as the court's opinion confirms, the odds are always with the house.

Round one was *Cohen I*, 578 F.3d 1, 388 U.S. App. D.C. 80 (D.C. Cir. 2009), where we determined the taxpayers could move forward with a challenge to Notice 2006-50. The Service, rocked but undaunted, tried again with a larger group of judges in *Cohen II*, 650 F.3d 717, 397 U.S. App. D.C. 33 (D.C. Cir. 2011) (en banc), arguing it was immune to suit outside the narrow confines of the refund process. Again, it failed—by split decision, the taxpayers won. On remand—round three—the district court found the IRS had violated the APA and vacated the offending notice, but it declined to set any timetable for further action.

The Service announced the demise of the refund notice and resolutely refused to take any other remedial action. Though there is no dispute about the unauthorized nature of the exaction, it intends to keep the unrefunded portions of its

ill-gotten gains—a few billion dollars. Indeed, the Service fares better than the Las Vegas casinos: even when they lose, they win. Since no law “unequivocally” requires the IRS to do the right thing, they have the discretion to do wrong. The taxpayers are out of luck. It was not always thus. . . .

The Service’s recalcitrance is disconcerting, and I do not share my colleagues’ confidence that no law imposes a duty upon the Service to create a *workable* refund scheme. . . .

- She concluded:

Once upon a time, public law concerned itself with notions of what was morally right, not just what was minimally required. But, as counsel for the Service has repeatedly reminded us throughout this litigation, those days are part of the dim (and not to be recaptured) past. *See* Appellee’s Br. at 37 (“After making the concession that limited the scope of ‘toll telephone service’ to which I.R.C. § 4252(b)(1) applied, the IRS was by no means required to notify every taxpayer potentially entitled to a refund, or even to publicize the availability of refunds.”). These days, no matter how unwarranted its exactions, whether the Service returns anything to the taxpayers—when circumstances do not fit the usual paradigm—is a decision within its sole discretion. Following the Service’s reasoning to its logical conclusion, the more larcenously it behaves, the lighter its obligations to plundered taxpayers become. No doubt this is a sign of the times, but it seems more an artifact of an administrative state gone deeply awry.

**2. The price of skin cancer is increased by the excise tax on tanning services.** T.D. 9621, Indoor Tanning Services; Excise Tax, 78 F.R. 34874 (6/11/13). Final Regulations § 49.5000B-1 are promulgated for collection of the 10 percent excise tax on indoor tanning facilities under § 5000B enacted as part of the Affordable Health Care Act. The tax is imposed on amounts paid for indoor tanning services. The final regulations generally adopt provisions in the proposed and temporary regulations. The regulations include an exemption for Qualified Physical Fitness Facilities, the predominant business or activity of which is to serve as a physical fitness facility that does not charge separately for indoor tanning services available at the facility. For other purveyors of indoor tanning, the tax applies to amounts actually paid for indoor tanning services that are provided at a reduced rate. The tax does not apply to services that are obtained by redemption of points

through a loyalty program. Where tanning services are bundled with other goods and services, the final regulations set out a formula to determine the amount reasonably attributable to indoor tanning services. With respect to gift cards, the tax is imposed when the card is redeemed specifically to pay for indoor tanning services and not when the card is purchased. The tax is also imposed on prepaid monthly membership and enrollment fees regardless of the services actually provided.

**a. The price of a tan goes up even in disregard of the hazard from which the owner is protected.** T.D. 9670, Disregarded Entities; Religious and Family Member FICA and FUTA Exceptions; Indoor Tanning Services Excise Tax, 79 F.R. 36204 (6/26/14). The Treasury has finalized, without substantive change, temporary and proposed regulations issued in 2012 that add the 10 percent excise tax on indoor tanning services of § 5000B to the list of excise taxes for which disregarded entities (QSub or single owner business entity) are treated as separate entities. These changes apply to taxes imposed on amounts paid on or after 7/1/12.

**3. The government prevails on the substantive issue whether an excise tax is due on S corporation shares held by an ESOP, but is barred from assessing the tax by the applicable period of limitations.** Law Office of John H. Eggersten P.C. v. Commissioner, 142 T.C. 110 (2/12/14). An ESOP owned all of the stock of the taxpayer, a subchapter S corporation. Under the ESOP, 100 percent of the stock of the taxpayer was allocated to John H. Eggersten, the individual who formerly owned the stock. The government and the taxpayer agreed that Mr. Eggersten was a “disqualified person” within the meaning of § 409(p)(4). Because the ESOP allocated all the stock of the S corporation to Mr. Eggersten, the shares were deemed-owned shares with respect to him under § 409(p)(4)(C) and he was treated as owning them for purposes of § 409(p) and the related excise tax imposed by § 4979A. The government argued that, because disqualified persons owned 50 percent or more of the number of shares of employer securities consisting of stock of an S corporation, a non-allocation year had occurred in 2005 within the meaning of § 409(p)(3). Accordingly, the government argued, under § 4979A(a), an excise tax was imposed on the S corporation equal to 50 percent of the “amount involved.” The government relied on a special rule in § 4979A(e)(2)(C), which provides that “the amount involved for the first nonallocation year of any employee stock ownership plan shall be determined by taking into account the total value of all the deemed-owned shares of all disqualified persons with respect to such plan.” Thus, the government sought to impose a tax equal to 50 percent of the value of the S corporation’s shares. The Tax Court (Judge Chiechi) agreed with the

government that § 4979A(a) imposed the tax for tax year 2005, but concluded that the period of limitations in § 4979A(e)(2)(D) for assessing the tax had expired before the government issued its notice of deficiency. In its analysis of the imposition of the tax, the court rejected the taxpayer's argument that § 4979A(a) does not impose an excise tax when a non-allocation year occurs. The court also rejected the taxpayer's argument that the "first nonallocation year" specified by § 4979A(e)(2)(C) was 1999, the year in which Mr. Eggerston transferred the S corporation shares to the ESOP, rather than 2005. In reaching this conclusion, the court relied on the effective date of the relevant provisions, which apply to plan years beginning after 12/31/04. Under § 4979A(e)(2)(D), the period of limitations for assessing the excise tax is three years from the later of the allocation or ownership giving rise to the tax or the date on which the Secretary is notified of the allocation or ownership. Section 4979A(e)(2)(D) does not define the term "notified." Relying on its approach to a similar issue in *Stovall v. Commissioner*, 101 T.C. 140 (1993), the court looked for guidance to the regulations issued under § 1033(a), which specify that a notification must contain "all of the details." The court concluded that the S corporation's 2005 return on Form 1120S and the employee benefit plan 2005 return on Form 5500, both filed in 2006, provided the requisite notification. The period of limitations on assessment therefore expired in 2009. Because the IRS did not issue the notice of deficiency until 4/14/11, assessment of the tax was precluded.

## **XII. Tax Legislation**

### **A. Enacted**

**1. Would this Act be better called the Political Cowardice Tax Act of 2014?** The Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, colloquially called the "Extenders Bill," was signed by the President on 12/19/14. The Tax Increase Prevention Act retroactively extended through 12/31/14 a myriad of deductions, credits, and special benefit provisions that had expired at the end of 2013. It did not address extension of these provisions, or any other expired provisions, to 2015.

