

FEDERAL TAX UPDATE

Important Developments in Federal Income, Estate & Gift Taxation Affecting Individuals August, 2009 to September, 2010

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This update explains several developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses. It contains summaries of significant cases, rulings, regulations, legislation and other matters from August, 2009, through August, 2010. This update generally does not discuss developments in the areas of qualified plans or the taxation of business entities (except to a very limited extent).

On November 6, 2009, President Obama signed the Worker, Homeownership, and Business Assistance Act of 2009. This legislation made important changes to the rules for net operating losses and the first-time homebuyer credit. These provisions are discussed herein and marked as “2009 Homeownership Act.”

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act. As its acronym suggests, the Act provides a number of incentives to hire and retain the unemployed in addition to a number of other business tax perks. Important changes from this Act are discussed herein and marked as “2010 HIRE Act.”

On March 23, 2010, President Obama signed the Patient Protection and Affordable Care Act, popularly known as the Health Care Bill. One week later, President Obama signed the Health Care and Education Reconciliation Act. Both Acts contains a number of tax provisions, though most will not become effective for several years. As a preview of coming attractions, this update covers some of the more interesting provisions from these two pieces of legislation, grouped together and marked herein as “2010 Health Care Act.”

On September 27, 2010, President Obama signed the Creating Small Business Jobs Act of 2010. The Act was one of several pieces of legislation signed that day designed to provide relief to small business owners. The Act extends several of the economic stimulus provisions that were introduced into the Code in the past few years. Key aspects of the Act are examined herein and tagged as “2010 Small Business Act.”

As of this point, Congress has not addressed many of the laws set to expire as of the end of 2010. It is likely that Congress will take no significant action until after the November elections, and perhaps even then it might be early 2011 before taxpayers will know exactly what to expect for 2011 and future years. We live in interesting times.

Section 36: First-Time Homebuyer Credit

2009 Homeownership Act: Okay, This is the Last Extension. We Mean It! Stop Smiling! On the eve of its expiration, Congress extended the first-time homebuyer credit for a second time, this time to include homes purchased under a contract entered into by April 30, 2010, provided the purchase closed no later than June 30, 2010 (later legislation changed this date to September 30, 2010). (The credit had been set to expire on November 30, 2009.) Along the way, Congress added several more important details to the § 36 credit, all generally applicable to purchases made on or after November 7, 2009. First, the credit is disallowed entirely where the purchase price exceeds \$800,000. Second, to thwart abuses of the credit, individuals under age 18 are ineligible to claim the credit (unless they are married to someone at least 18 years old at the time), and any taxpayer who can be claimed as a dependent on another’s return is likewise ineligible. Third, the phase-out thresholds were expanded. Previously, the credit phased out once the taxpayer’s modified adjusted gross income (adjusted gross income plus amounts excluded under §§ 911, 931, and 933) for the year of purchase exceeded \$75,000 and was fully phased out once the taxpayer’s modified adjusted gross income for such year reached \$95,000 (these figures were doubled for married taxpayers filing a joint return). Now, the phase-out does not kick in until the taxpayer’s modified adjusted gross income reaches \$125,000 (but the credit is fully phased out once modified adjusted gross income reaches \$145,000). Fourth, Congress clarified that homebuyers who purchased in 2009 but elected to claim the credit on their 2008 returns will not be subject to recapture unless, like all homebuyers in 2009, they sell their homes within three years of the purchase. Finally, and perhaps most significantly, a “long-time resident of the same residence” (one who has owned and used the same residence as his or her principal residence for a period of five consecutive years during the eight-year period ending on the date of the new home’s purchase) is treated as a first-time homebuyer(!), but such individuals are eligible to claim a maximum credit of \$6,500. *Section 36(b)(3) – (4), (c)(6), (d)(3).*

The following table summarizes the applicable rules in play depending on the date of purchase.

Date of Purchase	April 9, 2008 – December 31, 2008	January 1, 2009 – November 6, 2009	November 7, 2009 – September 30, 2010 (provided binding contract to buy executed on or before April 30, 2010)
Eligible Homebuyers	<p>“First-time homebuyer” (no ownership interest in a United States home within the 3 years prior to purchase)</p> <p>No credit at all if: (1) home purchased from a related party; or (2) home acquired by gift or inheritance</p>		<ul style="list-style-type: none"> • “First-time homebuyer” (no ownership interest in a United States home within the 3 years prior to purchase) • “Long-term resident of same residence” (owned and used a prior home for 5 consecutive years in the 8 years prior to purchase) <p>No credit at all for first-time homebuyer or long-term resident of same residence if: (1) home purchased from a related party; (2) home acquired by gift or inheritance; (3) purchase price exceeds \$800,000; (4) homebuyer is under age 18 and not married to someone who is at least age 18; or (5) homebuyer is a dependent of another taxpayer</p>

Date of Purchase	April 9, 2008 – December 31, 2008	January 1, 2009 – November 6, 2009	November 7, 2009 – September 30, 2010 (provided binding contract to buy executed on or before April 30, 2010)
Amount of Credit for First-time Homebuyer	Up to 10% of purchase price, but not to exceed \$7,500 (\$3,750 for MFS)	Up to 10% of purchase price, but not to exceed \$8,000 (\$4,000 for MFS)	Up to 10% of purchase price, but not to exceed \$8,000 (\$4,000 for MFS)
Amount of Credit for Long-term Resident of Same Residence	None		Up to 10% of purchase price, but not to exceed \$6,500 (\$3,250 for MFS)
Recapture of Credit	Homebuyer must pay additional tax equal to 1/15 of the credit claimed for 15 years, beginning in the second taxable year after the year in which the credit is claimed Recapture accelerated to year of disposition if the homebuyer disposes of the home before the recapture period has expired	No recapture of credit unless homebuyer disposes of new home within 3 years of purchase	

Section 41: Credit for Increasing Research Activities

Income From Foreign Branches Count in Computing R&D Credit. The taxpayer is a United States corporation that manufactures farm equipment. Its consolidated tax returns for 1997 through 2001 included income attributable to foreign branch operations in Europe. On its 2001 return, the taxpayer claimed a § 41 credit and elected to calculate the credit under the § 41(c)(4) “alternative incremental research credit” method. This required the taxpayer to calculate its average annual gross receipts for the four-year period preceding the 2001 return. In doing so, the taxpayer did not include the income from its foreign branch operations. This in turn allowed the taxpayer to claim a greater credit. The Service determined a deficiency after concluding that the gross receipts of the foreign branches should have factored into the computation. Doing so would mean the taxpayer’s average annual gross receipts for the four prior taxable years was \$13.37 million and not \$11.73 million as shown in the return. The Tax Court agreed with the Service’s approach and granted its motion for summary judgment. It rejected the taxpayer’s argument that the structure of § 41 implicitly restricted the definition of “gross receipts” to domestic receipts. “If Congress had wanted to exclude from ... the calculation ... the gross receipts of all foreign unincorporated trades or businesses (e.g., Deere’s foreign branches)..., it knew how to so mandate and would have so mandated. It did not. The silence of Congress is strident.” The court also rejected the taxpayer’s argument that legislative history supported its position. Finally, the court rejected the argument that because § 41 historically focused on domestic activities, “gross receipts” should be interpreted consistently to apply only with respect to domestic gross receipts. The court observed that while Congress has always excluded research conducted outside of the United States from the credit, the test was not whether the taxpayer is located, or does business, exclusively within the United States. *Deere & Co. v. Commissioner*, 133 T.C. No. 11 (October 22, 2009).

Section 61: Gross Income Defined

Really? You Have to Pay Tax on Income from Discharge of Debt? Really? The taxpayers hired a third party to negotiate the settlement of their debt to a credit card company. The negotiation was successful, and the taxpayers received a Form 1099-C from the credit card company that indicated the amount of debt cancelled. Trouble is, the taxpayers neglected to include that amount in gross income. When the Service determined a deficiency, the taxpayers asked the Tax Court for relief. Alas, the court was not sympathetic. The taxpayers claimed, apparently for the first time, that the debt owed to the credit card company was in dispute because of erroneous charges the invalid assessment of interest, penalties and fees. The Service argued it was too late to make this claim now, especially since they conceded at trial that they in fact originally owed the amount that was eventually discharged. The taxpayers then argued that they should be able to subtract the 25% fee paid to the third party—they don't ask for a deduction under § 162 or § 212, they just want to subtract the fee from the amount of debt discharge income. But the court rejected this position: "Petitioners suggest that they received no monetary benefit from the cancellation of the debt and for that reason argue that they should be allowed to offset their 'phantom' income' with the 'loss' they suffered when they paid the fee. We cannot agree with petitioners. Section 61(a)(12) manifestly does not provide for any kind of deduction." *Melvin v. Commissioner*, T.C. Memo. 2009-199 (September 8, 2009).

Reward Includable in Gross Income; Attorney's Fees are a Miscellaneous Itemized Deduction. The taxpayer sued his former employer, Lockheed Martin, in a "qui tam" action under the federal False Claims Act. The taxpayer claimed that the defendant submitted false information to the United States in the form of inflated charges relating to federal grants. In a qui tam action, a private party commences a lawsuit as an agent of the United States, and the agent gets a share of the government's recovery if the suit is successful. The taxpayer was supposed to receive \$8.75 million as his payment, but he only got \$5.25 million because the remaining \$3.5 million was subtracted from the recovery by the taxpayer's attorneys as attorney's fees. The taxpayer included no portion of the payment in gross income, contending a qui tam payment is not includible because it was a nontaxable share of the federal government's recovery. The Service took the position that the entire qui tam payment, including the portion paid to the attorneys, was includible in the taxpayer's gross income. The Tax Court agreed that the entire award was includible. A 2003 case from the Tax Court states that a qui tam payment is like a reward, and the court affirmed that analysis here. The court also held that the taxpayer could deduct the portion payable to the attorneys, but only as a miscellaneous itemized deduction. The court upheld the imposition of an accuracy-related penalty because the omission from gross income resulted in a substantial understatement of income tax, but the penalty would not apply to the attorney-fee portion of the award because there was adequate disclosure of this position on a Form 8275 and the taxpayer had a reasonable basis for that position. There was neither authority nor a reasonable basis for excluding the rest, however, so the court did not abate the penalty any further. *Campbell v. Commissioner*, 134 T.C. No. 3 (January 21, 2010).

Award of Attorney Fees to Pro Bono Lawyers Excluded From Client's Income. The taxpayer was represented in a lawsuit by two legal aid organizations and a law firm on a pro bono basis. The taxpayer was not obligated to pay any legal fees to the legal aid organizations or the law firm for their work on the matter. The taxpayer won the lawsuit and was awarded the maximum recovery provided by law. Because the law permitted the taxpayer to recover reasonable attorney's fees for this type of action, one of the legal aid organizations and the law firm filed a motion for attorney's fees which the court granted. The taxpayer is worried that the amount payable to the lawyers must be included in the taxpayer's gross income, but the Service ruled that the attorney fee award is not includible in gross income here. Yes, a Supreme Court case from 2005 holds that where the portion of a plaintiff's recovery from a money judgment or settlement is paid to the plaintiff's attorney under a contingent fee

arrangement, that portion is included in the plaintiff's gross income. But the Service said this situation is different. The taxpayer here never had the obligation to pay any attorney's fees. Furthermore, the legal aid organization and law firm that filed a motion for attorney's fees did so directly (and not on behalf of the taxpayer). Thus, the Service concluded that the award of attorney's fees is excludible from the taxpayer's gross income. *Private Letter Ruling 201015016* (April 16, 2010).

Section 67: 2-Percent Floor on Miscellaneous Itemized Deductions

No Fooling: Treasury Again Extends Relief for Bundled Fiduciary Fees. In *Knight v. Commissioner*, a 2008 decision, the Supreme Court held that fees paid to an investment advisor by a trust or estate are subject to the § 67 limitation on miscellaneous itemized deductions. Immediately after that decision, Treasury announced that, pending the issuance of new regulations that comply with *Knight*, investment advice fees and other costs normally subject to § 67 that are bundled as part of one commission or fee paid to the trustee or executor (so-called "bundled fiduciary fees") would *not* be subject to § 67 if they were paid or incurred before 2008. If the trustee or executor was separately reimbursed for expenses subject to § 67, however, such payments would be subject to § 67. In issuing that announcement, Treasury expected that new regulations with safe harbors for use in allocating bundled fiduciary fees between costs subject to §67 and those not subject to §67 would soon be forthcoming. Alas, they were not. So late in 2008, Treasury extended the relief for bundled fiduciary fees to include all such payments in all taxable years beginning before 2009. Well, the regulations still have not been issued, so Treasury has again extended the relief, this time applicable to all such payments in all taxable years beginning before 2010. Aren't annual extensions fun? They're so much better than a single notice that provides relief to all payments made in all taxable years beginning before the date on which regulations are finally proposed. Or maybe not. *Notice 2010-32* (April 1, 2010).

Section 72: Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

Taxpayer Wasn't Disabled, So 10% Penalty Applied to Hardship Distribution. In 2005, the taxpayer, a nurse for the Department of Veterans Affairs, received an in-service financial hardship distribution of just over \$158,000 from his qualified plan. Because he had not reached age 59-½, however, the Service assessed the ten percent addition to tax. The taxpayer claimed that because he suffered from post-traumatic stress disorder, depression, and bipolar disorder (all conditions diagnosed in 2004 following the death of a patient in the taxpayer's care), the disability exception to the ten-percent penalty under § 72(t)(2)(A)(iii) applied. The Tax Court agreed with the Service that the taxpayer was not "disabled" for purposes of this exception. The statute requires that one be unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that is expected to last indefinitely or result in death. Here, however, the taxpayer's doctor expected that the taxpayer would make a full recovery and that treatment would not require institutionalization or constant supervision. It probably did not help that the taxpayer continued working for the VA in 2005 (at the same pay grade and salary as before his diagnosis). He was even able to manage the family farm that year, even though doing so required him to travel a significant distance many times over. *Dollander v. Commissioner*, T.C. Memo 2009-187 (August 19, 2009).

Levy Exception to Ten-Percent Penalty Requires Actual Levy. In 2004, when the taxpayer was under age 59 ½, he withdrew \$397,994.60 from his individual retirement account. He used \$57,172.31 of the distribution to pay his unpaid federal income tax liabilities for 2001, 2002, and 2003. The rest of the proceeds were used to pay health insurance premiums of \$16,763.86, qualified higher education expenses of \$11,539.76, state tax liabilities to New Jersey, Pennsylvania, and Delaware, mortgage liabilities, real estate taxes, and credit card debt. The taxpayer included the entire distribution in gross income on his

2004 joint return, but he did not pay the 10% penalty on the early distribution. Before the Tax Court, the taxpayer conceded that he owed the penalty with respect to that portion of the distribution used for State tax liabilities, mortgage liabilities, real estate taxes, and credit card debt. But he claimed that the penalty should not apply to that portion used to pay his federal income tax liabilities because that distribution was “made on account of a levy under section 6331 on the qualified retirement plan” and thus excepted from the penalty under § 72(t)(2)(A)(vii). The Tax Court did not buy the argument, since the Service’s Notice of Intent to Levy was issued *after* the taxpayer’s withdrawal. Besides, before levying a taxpayer’s assets to satisfy an unpaid federal tax liability, § 6330(a)(1) requires the Service to notify the taxpayer in writing of the taxpayer’s right to a hearing before such levy is made. No such notice had been issued to the taxpayer, so no levy could have occurred. Thus, the 10% penalty applied to the entire withdrawal. *Willhite v. Commissioner*, T.C. Memo. 2009–263 (November 18, 2009).

Section 104: Compensation for Injury or Sickness

Proposed Regulations Finally Account for Changes Made to the Statute in 1996. It took 14 years, but Treasury has finally proposed new regulations that would take into account changes made to the § 104(a)(2) exclusion made under the Small Business Job Protection Act of 1996. Most importantly, the proposed regulations omit the requirement in the current regulations that damages received from a lawsuit or settlement agreement be based upon “tort or tort type rights” in order to qualify for the exclusion. Under the proposed regulations, damages for physical injuries or physical sickness may be excluded even though the injury giving rise to the damages is not defined as a tort under state or common law. Furthermore, the exclusion does not depend on the scope of remedies available under state or common law. This revised standard permits the exclusion of damages awarded under no-fault statutes. The proposed regulations will, if finalized, apply to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after the date the regulations are finalized. Taxpayers may, however, elect to apply the proposed regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after August 20, 1996. *Proposed Regulation § 1.104-1(c)* (September 15, 2009).

Depression Not Enough to Trigger Exclusion. The taxpayer sued her employer, the Colorado Department of Transportation, her supervisor, and her supervisor's superior. She alleged gender discrimination and brought a § 1983 claim and Title VII claim for retaliation. The taxpayer maintained that the stress she faced due to altercations with her supervisor and the perceived inaction by the Department resulted in her seeking therapy, taking extended leave, and eventually being terminated. The parties settled when the taxpayer agreed to receive \$175,000 “as damages for her emotional distress due to depression and other claims, not as wages or back pay.” The taxpayer excluded the settlement payment from gross income, but the Service concluded that § 104(a)(2) did not apply and that the payment should have been included in gross income. The Tax Court held that the settlement payment was not covered by the § 104(a)(2) exclusion. She received damages for emotional distress due to depression, and the statute expressly provides that emotional distress by itself is not a physical injury or physical sickness. The settlement here was attributable to her claims of gender-based discrimination and unlawful retaliation with respect to her employment, not to any physical injury or sickness. The taxpayer argued that because “depression” is not specifically excluded as a physical injury under the statute, it was within the scope of a “physical injury.” The Court correctly rejected this argument, observing that the correct standard for claiming an exclusion is to show that the taxpayer falls within the clear scope of the exclusion provision. Just because depression is not excluded from the definition of physical injury does not mean depression is a physical injury. *Wells v. Commissioner*, T.C. Memo. 2010-5 (January 5, 2010).

Employer's Recordkeeping Reflects Intent to Compensate for Physical Sickness. Four years before obtaining a job as a fundraiser for her employer, the Pacific Autism Center for Education, the taxpayer was diagnosed with multiple sclerosis. The taxpayer had a strained relationship with her employer, and the hostile work environment exacerbated her MS symptoms. When she learned that her boss was embezzling, she reported the knowledge to several directors who assured her they would handle the matter. But they did not, and the taxpayer's unease made the symptoms even worse. By early 2005, the taxpayer's physician advised her to take two weeks off from work because her symptoms ("Vertigo, shooting pain in both legs, difficulty walking due to numbness in both feet, a burning sensation behind her eyes, and extreme fatigue") had become too debilitating. The physician faxed a notice to the employer advising it of his recommendation. That same day, the employer fired the taxpayer. The taxpayer hired a lawyer, who negotiated a settlement with the employer. The employer paid \$33,308 to the taxpayer, of which \$8,187.50 consisted of compensation due. The employer paid the compensation plus another \$16,933 to the taxpayer in the taxable year at issue. The taxpayer included the compensation portion but excluded the \$16,933 under § 104(a)(2). The Service contended that the settlement was not paid on account of physical injury or physical sickness, so it determined that the taxpayer should have included all amounts received. The Tax Court held that the exclusion applied. The court implied that the case would have been easier to decide if the settlement agreement had been clearer as to what the payments were compensating. Given the ambiguity, the court had to take its best guess as to the intent of the parties. It was telling, according to the court, that the employer included the compensation payment on the taxpayer's Form W2 but reported the \$16,933 payments on a Form 1099-MISC as "nonemployee compensation." As the court explained, "[t]he differing tax and reporting treatments used for the three payments show that PACE was aware that at least part of petitioner's recovery may not have been subject to tax; i.e., was due to physical illness. Coupled with that inference is the fact that petitioner advised PACE of her illness before her employment was terminated and the likelihood that her attorney represented petitioner's circumstances to PACE in the course of the settlement negotiations. Petitioner made no other claim. We find that PACE intended to compensate petitioner for her acute physical illness caused by her hostile and stressful work environment." *Domeny v. Commissioner*, T.C. Memo. 2010-9 (January 13, 2010).

Arrest and Strip-Search Didn't Cause Physical Injuries. Late in 1996, the taxpayers, a married couple, bought a used car for their son, paying a dealership \$1,200 of the \$3,430 purchase price in the form of two checks, one for \$100 and another for \$1,100. After driving the car for seven (!) miles, it broke down. The taxpayers had to spend almost \$500 to get the car repaired. They phoned the dealership several times to discuss the car, but "their calls were ignored, placed on hold for long periods of time, and not returned." So the wife placed a stop payment order on the \$1,100 check, indicating "dissatisfied purchase" as the reason for the order. The bank incorrectly stamped the check "NSF" (nonsufficient funds) and returned it to the dealership. In February, 1997, the dealership filed a criminal complaint against the wife for writing a bad check. A few weeks later, police arrested the wife "at her home in the presence of her husband, her daughter, and a family friend." She was handcuffed, hauled to the local detention center, and booked for holding. Later that night she was transferred to a county jail, where she was strip-searched and "required to ... wear an orange jumpsuit." Though she was then indicted on charges of theft by deception, the charges were later dropped. Two years later, the wife sued the dealership and the bank (alleging malicious prosecution against the dealership and negligence by the bank) seeking damages "including, but not limited to, nominal damages, compensatory damages and special damages, including, but not limited to, attorney's fees to defend, lost time and earnings, mortification and humiliation, inconvenience, damage to reputation, emotional distress, mental anguish, and loss of consortium." In 2002, the bank and the taxpayers settled when the bank agreed to pay \$49,000 to the wife. Apparently, there was a 2001 settlement between the wife and the dealership, but no details of that settlement are provided. On their joint return for 2002, the taxpayers did not include any portion of the settlement in gross income even though they received a Form 1099-MISC from the bank. The Service assessed a deficiency and an accuracy-related penalty. Before the Tax Court, the taxpayers

argued that the settlement is excluded under § 104(a)(2). The court observed that the § 104(a)(2) exclusion applies only to claims “based upon tort or tort type rights.” The Service argued that the wife’s claim against the bank was contract claim and not a tort claim, but the taxpayers said the settlement was paid on account of the wife’s arrest and detention, which constituted the tort of false imprisonment. The court noted that applicable state law (Kentucky) provides that a customer may have a tort claim against a bank for wrongful dishonor of a check, and it saw the wife’s claim here as a tort claim. “It is incorrect to characterize [the] wife’s complaint against [the bank] as a contract claim or merely a dispute over the wrongful dishonor of a check. Rather, [the] wife decided to sue [the bank] because of the ordeal she suffered as a result of her arrest and detention. [The] wife did not suffer an economic loss from [the bank’s] alleged mishandling of her check. She did not sue [the bank] to recover on economic rights arising from a contract with [the bank]. [The] wife sought damages against [the bank] that resulted from her arrest, detention, and indictment. She alleged damages associated with tort type rights: Emotional distress, mental anguish, mortification, humiliation, and damage to reputation. Although [the bank] did not initiate the criminal proceedings against [the] wife, the erroneous marking of the check for insufficient funds precipitated the arrest.” But that’s only part of the way to the exclusion: the wife must also show that the settlement was paid on account of physical injury or physical sickness. And this, the court concluded, she did not do: “Physical restraint and physical detention are not ‘physical injuries’ for purposes of § 104(a)(2). Being subjected to police arrest procedures may cause physical discomfort. However, being handcuffed or searched is not a physical injury for purposes of § 104(a)(2). Nor is the deprivation of personal freedom a physical injury for purposes of § 104(a)(2). . . . The damages sought by [the] wife against [the bank] are stated in terms of recovery for nonphysical personal injuries: Emotional distress, mortification, humiliation, mental anguish, and damage to reputation. These types of injuries are not excludable under § 104(a)(2).” The court thus sustained the deficiency, but it rejected the accuracy-related penalty, finding reasonable persons could disagree as to whether the taxpayers needed additional advice as to the tax treatment of the settlement. On appeal, the Sixth Circuit affirmed. It rejected a number of arguments advanced by the taxpayer, including: (1) that she suffered a physical injury because physical restraint and detention and the resulting deprivation of personal liberty was itself a physical injury; (2) that the settlement payment was not income because it only made her whole and did not enrich her to any extent; and (3) that § 104(a)(2) is unconstitutionally narrow since damage awards generally are not accessions to wealth and thus not income in the first place. *Stadnyk v. Commissioner* (6th Cir., February 26, 2010).

Section 107: Rental Value of Parsonages

Is This the End of Days for the Parsonage Allowance? Section 107 allows a member of the clergy to exclude from gross income the rental value of a home furnished as compensation for carrying out his or her duties (or any rental allowance to the extent it is used to rent or provide a home and to the extent the allowance does not exceed the fair rental value of the home, its furnishings, and reasonable appurtenances). Section 265(a)(6) also provides that a member of the clergy may deduct taxes and interest paid in connection with an exempt parsonage allowance. So even where a member of the clergy uses an excluded rental allowance to pay mortgage interest and taxes on a home, he or she can still claim mortgage interest and taxes as itemized deductions. A nonprofit organization filed suit asking for a declaration that §§ 107 and 265(a)(6) violate the Establishment Clause of the United States Constitution. The defendants moved to dismiss for lack of subject matter jurisdiction and failure to state a claim. The district court held that the organization has standing to bring its claim. Under *Flast v. Cohen*, a 1942 Supreme Court case, taxpayers have standing when they allege that Congress’s exercise of power under the Taxing and Spending Clause violates the Establishment Clause. Here, then, said the court, the organization has standing to challenge §§ 107 and 265(a)(6). As for the failure to state a claim, the organization claims that § 107 provides an exclusion for members of the clergy that is not available to similarly situated secular employees. According to the court, this raises the possibility that § 107 goes too

far in aiding and subsidizing religion, so the organization has stated a claim upon which relief may be granted. The organization also claims that § 265(a)(6) impermissibly confers a double benefit to members of the clergy by giving them both a tax-free housing allowance and deductions for interest and property taxes. Here, however, the court observed that the organization alleged no facts that show that § 265(a)(6) is anything other than a provision that gives ministers (and members of the armed forces) the same incentive as every other taxpayer to purchase a home. Indeed, the absence of a deduction for taxes and mortgage interest could unfairly burden members of the clergy. Accordingly, the court granted the defendants' motion to dismiss as regards § 265(a)(6). But stay tuned for further analysis as to the constitutionality of the § 107 exclusion. *Freedom from Religion Foundation, Inc. v. Geithner*, (E.D. Cal., May 21, 2010).

Ordained Employees of Church-Related Foster Care Organization Eligible for Parsonage Allowance Exclusion. The taxpayer is a § 501(c)(3) organization that operates a foster care program for kids and offers assistance to displaced single-parent families. It owns three group homes and conducts an active parent ministry. The taxpayer is and always has been supported primarily by members of "Church," a "confederation of churches" that, for theological reasons, does not have a central governing body. The taxpayer gets over 95% of its financial support from Church. The taxpayer's mission is "to be a tool in the hands of supporting [Church] and individual Christians to deliver God's justice and mercy to children and families in need." The taxpayer requires all trustees, officers, and full-time permanent employees to be members of Church, and they are expected to attend services on a regular weekly basis and be involved in ministries of Church. A trustee of the taxpayer may be removed from the board for failure to be a Christian role model, for excessive absence from regular or special meetings of the board, or when in the board's judgment removal would be in the taxpayer's best interest. The taxpayer sought a ruling that rental allowances paid to managers, executives, supervisors, or administrators in its employ who are ordained, licensed, or commissioned ministers can be excluded from gross income. Finding that the taxpayer is an integral agency of a church, the Service granted the taxpayer's request. *Private Letter Ruling 201023008* (June 11, 2010).

Section 108: Income from Discharge of Indebtedness

Final Regulations Explain Reduction to Tax Attributes for S Corporations. When a taxpayer excludes income from the cancellation of debt (COD income) under § 108, § 108(b) requires the taxpayer to reduce his, her, or its "tax attributes" by the amount excluded. In effect, the income is not forgiven but merely deferred. The statute contains a hierarchy of tax attributes from which the reduction is to be made, starting with the net operating loss carryover and then through other credit and loss carryovers before hitting the taxpayer's basis in assets. Treasury has finalized regulations offering guidance as to how an S corporation reduces its tax attributes under this rule in years when it has excludable COD income. Under the new regulations, the reduction of tax attributes occurs at the corporate level. The § 1366 pass-through will not include any excludable COD income, so shareholders will not make any stock basis adjustments for this income. The regulations provide that the reduction in tax attributes occurs after the pass-through of tax items to shareholders. For purposes of § 108(b), say the proposed regulations, any suspended loss or deduction under § 1366(d) is treated as a net operating loss of the corporation. If the amount of this "deemed NOL" for the S corporation exceeds the amount of excluded COD income, the excess must be allocated to its shareholders as additional suspended losses and deductions for the taxable year of the discharge. (If the corporation had multiple shareholders during the taxable year of the discharge, the regulations provide rules for determining the amount of excess deemed NOL allocated to each shareholder.) The proposed regulations provided that, to be consistent with the ordering rule in § 108(b), in determining the character of the amount of the corporation's excess deemed NOL that is allocated to a shareholder, any ordinary loss or deduction that was disallowed under § 1366(d) but included in the corporation's deemed NOL would be treated as reduced before any capital loss that was disallowed under §

1366(d) and that was included in the corporation's deemed NOL. The final regulations, however, adopt an approach that Treasury thinks is more consistent with §1366(d): the corporation's excess deemed NOL allocated to a shareholder consists of a proportionate share of each item of the shareholder's loss or deduction that is disallowed for the taxable year of the discharge. Section 1231 losses are reduced after any ordinary loss and before any capital loss. The new regulations apply to discharges of indebtedness occurring on or after October 30, 2009. *Regulation § 1.108-7(d)* (October 30, 2009).

Section 121: Exclusion of Gain from Sale of Principal Residence

Golly! Unanticipated Military Assignment is an Unforeseen Circumstance. The taxpayers, a married couple, purchased a home in March of Year 1 and owned it until its sale in Year 25. The husband was a member of the armed services throughout this period. The couple lived in the home during those periods when the husband was assigned to work nearby. At times, however, the husband was required to live in government quarters or to work outside the local area. During those times, the couple rented the house to tenants and claimed depreciation deductions. In fact, the couple never occupied the home after Year 12. The couple hoped that upon the husband's retirement in Year 25 they could live in the home happily ever after. But the husband received an assignment in Year 25 that postponed retirement plans. And since the new assignment required the husband to live in government quarters, the couple decided to sell the home. Of course, since they had not used the home as their residence for any of the five years prior to the sale, they could not use the § 121(a) exclusion (even after making use of the 10-year tolling of the five-year look-back period available to members of the armed forces under § 121(d)(9)). They hoped, however, to make use of the reduced exclusion under § 121(c). Remarkably, the Service ruled that the reduced exclusion applied because "the primary reason for the sale was [the husband's] unanticipated assignment that was a change in the place of employment. This was also an unforeseen circumstance. First, in Spring Year 25, [the husband] expected to retire after completing his assignment at Installation and [the] Taxpayers intended to return to the Area and live in [the home] as their principal residence after [the husband] retired. The dates between learning of the change in employment and the sale of [the home] are proximate in time. Next, pursuant to the assignment [the husband] was under orders to live in government quarters, and [the] Taxpayers could not live at [the home]. Accordingly, the suitability of [the home] materially changed after the unanticipated assignment. Finally, [the] Taxpayers could not have anticipated the assignment at the end of [the husband's] career when [the husband] purchased [the home]." *Private Letter Ruling 200947024* (November 20, 2009).

Tax Court Demolishes Taxpayer's Claim for Exclusion. The taxpayers owned and used a house as their principal residence for at least two years. When the taxpayers sought to remodel their home, an architect advised them that more stringent building and permit restrictions had been enacted since the house was originally built. Apparently, it would be cheaper for the taxpayers to demolish the existing home and build another one. So that's what they did. But then, before they ever occupied the new home, they sold the property for a gain of about \$591,000. At first they excluded the entire gain, but eventually they agreed that the amount in excess of \$500,000 should be included in gross income. This case concerns the fight over the other \$500,000, for the taxpayers contend that they qualify for the \$500,000 exclusion applicable to joint filers under § 121(a). The Service argues that since they never occupied the new house, they fail the two-year ownership and use test to qualify for the exclusion. The taxpayers say the exclusion applies to the "property," which they read to mean the land on which the old and new houses sat. But the Service says that § 121(a) requires the "property" to be used as the "principal residence," which means the "property" in question is the structure itself and not the underlying land. The Tax Court conceded that the statute is ambiguous on this point but, in a 9-5 decision, ultimately favored the Service's interpretation. The majority was persuaded by the legislative history to § 121, which included frequent references to "house" and "home" interchangeably with "property." "The legislative history demonstrates that Congress intended the term 'principal residence' to mean the primary

dwelling or house that a taxpayer occupied as his principal residence. Nothing in the legislative history indicates that Congress intended section 121 to exclude gain on the sale of property that does not include a house or other structure used by the taxpayer as his principal place of abode. Although a principal residence may include land surrounding the dwelling, the legislative history supports a conclusion that Congress intended the section 121 exclusion to apply only if the dwelling the taxpayer sells was actually used as his principal residence for the period required by section 121(a).” The court concedes that if the taxpayers had sold the old home before demolition the § 121(a) exclusion would apply, but “we must apply the statute as written by Congress. Rules of statutory construction require that we narrowly construe exclusions from income.” The dissenters counter that “the Supreme Court has also said that, if the meaning of a tax provision liberalizing the law from motives of public policy is doubtful, then it should not be narrowly construed.” To illustrate the implications of the majority’s interpretation, the dissenters posit a similar situation involving a taxpayer whose home is destroyed in a hurricane. “The taxpayer lacks insurance. Nevertheless, she rebuilds on the same land (perhaps a bit further from the ocean) and lives in the rebuilt house for 18 months, and then she sells the house and land at a gain. Although the taxpayer satisfies the property use condition, I assume that, nevertheless, under the majority’s analysis, she gets no exclusion because she fails the temporal condition; i.e., she has not lived in the rebuilt house for 2 or more of the last 5 years. I assume further that, if her house had been only damaged (and not demolished), and she repaired it, she would get an exclusion. That seems like an untenable distinction to me.” Further, say the dissenters, the majority’s approach creates an artificial distinction between those who remodel and those who demolish and build anew. The better view, they contend, is to treat a demolition like a renovation and thus enable the taxpayers to claim the exclusion. *Gates v. Commissioner*, 135 T.C. No. 1 (July 1, 2010).

Section 162: Trade or Business Expenses

Two-Year Hiatus Means Taxpayer Started New Business. The taxpayer worked as a contract attorney before 1988, when she took a job as a securities regulator for the California Department of Corporations. When her employment was terminated in 2000, she returned to working as a contract attorney, but only briefly. She did not work as a contract attorney in 2001 or 2002. Come 2003, though, she decided to try contract work again. To revive her career, she attended an ABA meeting and, while there, attended various seminars on securities law. She also bought a computer, a printer, paper products, and internet services. Before she had the chance to get any clients or earn any income as a contract attorney, she was reinstated by the California Department of Corporations (if it matters, she sued the Department for reinstatement). On her 2003 return (if it matters, it was filed in 2006), she deducted the costs to attend the conference as well as the other costs described above, though not as business expenses. When the Service later assessed a deficiency based on alternative minimum tax liability, the taxpayer petitioned the Tax Court and argued that the costs should be deductible as business expenses. The court agreed with the Service that the taxpayer was not engaged in the trade or business of being a contract attorney when the expenses were paid. The taxpayer was not continuing an existing trade or business because she “did not work as a contract attorney in 2001 or 2002, and her activity in 2003 was sporadic.” Viewing this as a “new” venture for the taxpayer, the court was not impressed that she only devoted just over two months to the activity before finding other work. “This is not a substantial time period.” As for whether her work in 2003 rose to the level of a business, the court observed that “[e]ven though petitioner expended some time and effort in an attempt to find work as a contract attorney during this period, her involvement was not regular and continuous. Her only activity was her attendance at the ABA meeting for 4 days in February, at which petitioner marketed herself to other attorneys. She did not negotiate for or perform any legal services as a contract attorney for any party during this period. Finally, she abandoned her efforts upon returning to the department in late March. Accordingly, her activity was neither regular nor continuous.” Accordingly, the costs were not deductible as business expenses. *Forrest v. Commissioner*, T.C. Memo 2009–228 (October 5, 2009).

Fraud Restitution Payments Deductible as Business Expenses. Here's reason #436 not to work with your spouse. The taxpayers, a married couple, worked together in a dentistry practice. The husband was the dentist and the wife was the bookkeeper. Unbeknownst to the husband, the wife billed an insurance company for work the husband had not performed. The taxpayers included the overcharges as income on their tax returns. Eventually, the wife was caught, and she pled guilty to fraud. She promised to pay the insurance company \$600,000 to "settle all civil claims against [the taxpayers]." The husband paid the money and now seeks to deduct the payment either as a business expense or as a business loss. The Service is willing to give them a deduction, but it insists that the payment is a loss from a transaction (the fraud) entered into for profit. Of course, if the loss is characterized as an investment loss instead of a business loss, the loss cannot give rise to a net operating loss. The Tax Court held that the payment was deductible as a business expense. "The Commissioner very much wants us to find that the payments were [the wife's and not from the business], that they were 'restitution', and that she made them as part of her plea deal. We do agree, and find as a matter of fact, that the payments were restitution.... On the assumption that some restitution payments are nondeductible under [§ 162] we first ask whether the restitution here was punitive. If it was, the deduction may be barred; if it wasn't, then we will need to ask whether it is an otherwise ordinary and necessary expense of [the husband's] dentistry business." Here, the court held, the restitution was not punitive. The wife was already sentenced to prison and supervised release, and the amount paid bore a close relationship to the amount milked from the insurance company, so the payment served more as compensation to the insurance company. The Service argued that the payment related to the fraud and not to the dentistry practice, meaning the expenses were not business expenses. But the court said that "deductibility [under § 162] depends on the relation of the payment to the business claiming the deduction; in other words, don't look at the situation from the perspective of the embezzling employee, but from that of the business actually claiming the deduction and see if there is a reasonable business purpose for repayment." Here there was, according to the court. It believed the husband's testimony that he would have lost his business if he had not paid the insurance company. That the wife could not deduct the payment as a business expense on the joint return does not affect the ability of the husband to claim the very same cost as a business expense on the joint return. *Cavaretta v. Commissioner*, T.C. Memo. 2010-4 (January 5, 2010).

CPA Not Engaged in the Business of Farming. The taxpayer is a CPA specializing in forensic accounting. He co-owns his own accounting firm. In 2001, using a single-member LLC, the taxpayer acquired a farm that "consisted of 100 acres of higher ground, containing pastures, woodlands, and [a] residence; and 100 river-bottom acres planted in soybeans by Charles Honey (Mr. Honey) pursuant to an oral agreement with [the former owner]. Under the agreement Mr. Honey was to deduct the cost of chemicals and fertilizer from the total sale proceeds of the soybeans and pay [the former owner] one-third of the net proceeds of the sale." The taxpayer lived 150 miles from the farm, so instead of meeting Mr. Honey in person, he telephoned him and agreed orally to continue with the same arrangement. In 2002, the taxpayer decided to change from planting soybeans to Bermuda grass on the river-bottom acres. Because of a misunderstanding that led to a falling out between the two, Mr. Honey planted wheat on the property. The wheat crop was never harvested, and was eventually plowed under in the spring of 2004, shortly before the first planting of Bermuda grass that June. The taxpayer bought two tractors in 2002 and another tractor and hay equipment late in 2003. Also in late 2003, the taxpayer bought another 50 acres from a neighbor for Bermuda grass cultivation. The Service determined that because the taxpayer was not engaged in the trade or business of farming in 2002 and 2003, he could not claim depreciation and expenses as Schedule F deductions on his returns for those years. The Tax Court agreed, concluding that the taxpayer's farm-related activities did not rise to the level of a trade or business. It did not matter that the United States Department of Agriculture considered Mr. Honey and the taxpayer to be actively engaged in farming as co-producers for the USDA, and the taxpayer could not impute Mr. Honey's farming activities to himself. In fact, Mr. Honey paid all expenses with respect to the 2002 soybean crop and provided the equipment and labor. Mr. Honey also made all decisions with respect to the crop,

including what crop to plant, when to plant it, what equipment to use, when to spray for weeds, when to harvest, and when and where to sell the soybeans. During 2003, the taxpayer did not plant, cultivate, or tend a crop of any kind, and his farm-related activities were not continuous or regular. According to the court, the taxpayer did not establish that a trade or business began with respect to soybeans, Bermuda grass, or any other crop during these years. So deducting the costs as business expenses was out of the question. The court observed that the taxpayer may have been able to treat the depreciation and other costs as start-up expenditures eligible for amortization under § 195, but the taxpayer never made the election and it's too late now. Accordingly, the taxpayer's costs had to be capitalized. *Vianello v. Commissioner*, T.C. Memo. 2010-17 (February 1, 2010).

Section 163: Interest

Occupant of Home Entitled to Mortgage Interest Deduction. In 2003, Michael and Zina Gedz transferred legal and equitable title in a residence to a trust. Through a series of transactions later that year, the taxpayer received a beneficial interest in the trust. The taxpayer thus moved into the residence in June 2003 and lived there for five years. During that time he replaced the cedar deck for about \$1,700 and installed an automatic garage door opener for about \$500. He paid over \$2,000 for landscaping and installation of better basement windows. Despite these and other improvements paid for by the taxpayer, the property's value declined, so at the end of the five-year term, the taxpayer did not exercise his right of first refusal to purchase the property. The taxpayer made the monthly mortgage payments of \$2,900 per month on all loans secured by the property. According to the court, the fair rental value of the property was about \$1,500 per month. The taxpayer claimed mortgage interest deductions of \$24,135 in 2003 and \$23,471 in 2004, which the Service disallowed because the taxpayer was not the owner of the home. The regulations are clear that one with legal or equitable title can claim the deduction for mortgage interest if that person actually paid the interest, even if the debt is formally in the name of another. Thus, the taxpayer's ability to claim the deduction depends on whether he had legal or equitable title to the house. The Tax Court noted that some facts weigh in favor of finding that the taxpayer had assumed the benefits and burdens of ownership of the property, including his duty to repair or maintain the property under an agreement with the original owners, his duty to insure the property, his duty to pay property taxes, his right to proceeds from rents, mortgages, or sales, his right to obtain legal title at any time by paying the balance of the purchase price, and his agreement to pay the mortgage principal and interest. "In short, [the taxpayer] treated the ... property as if he owned it." But there were also facts indicating he lacked the benefits and burdens of ownership, including his choice not to exercise his right of first refusal and walk away from the property, the need to enter into an occupancy agreement with the trust to take possession of the property, and the inability to make material alterations or improvements to the property without obtaining certain consents. All in all, said the court, "we conclude that the benefits and burdens that favor ownership outweigh the factors against ownership. Petitioner has assumed the benefits and burdens of ownership of the ... property. Petitioner, therefore, is entitled to the mortgage interest deductions. *Adams v. Commissioner*, T.C. Memo. 2010-72 (April 13, 2010).

Section 165: Losses

Ongoing Lawsuit is Obstruction to Taxpayer's Claimed Loss Deduction. The taxpayer is in the business of residential real estate construction. In its 2002 taxable year, the taxpayer bought four adjoining parcels in Northern Idaho for about \$290,000. The taxpayer hoped to build homes on the sites and sell them at a profit. The taxpayer used an access road that crossed a neighbor's property in order to reach the lots. In 2002, the neighbor sued for trespass. On its 2002 return, the taxpayer deducted the price of the lots as part of its cost of goods sold. It took the position that the properties had become worthless thanks to the ongoing trespass suit. In 2003, the taxpayer lost the litigation with the neighbor.

In 2004, a court ordered the taxpayer to pay over \$80,000 in exemplary and punitive damages. The taxpayer's title company issued a check to the taxpayer, but the taxpayer gave the check to its attorney, who deposited the funds into his client trust account. Meanwhile, the taxpayer appealed the trespass case. The taxpayer lost all appeals and litigation finally concluded in 2008. The Service reduced the taxpayer's cost of goods sold reported on the 2002 return by the cost of the parcels. The Tax Court agreed that there was no basis for including the cost of these parcels in inventory costs. The taxpayer argued that it was entitled to a loss deduction in 2002 equal to the amount paid for the parcels, but the court rejected this position. There was no loss "sustained" in 2002 because the lawsuit with the neighbor was still ongoing as of the end of that year. Although the taxpayer claimed the properties had become worthless, there was no evidence to support this except for the taxpayer's own speculation. Finally, said the court, even if a loss had been sustained, a deduction would be premature because the taxpayer still had a right of recovery from the title insurance company as of the end of 2002. Heck, the taxpayer even received a recovery of title insurance proceeds in 2004. So there was no basis for a loss deduction. *D.L. White Construction, Inc. v. Commissioner*, T.C. Memo. 2010-141 (June 28, 2010).

Section 167: Depreciation

Street Lights Lack Class Life. The taxpayer provides street and highway lighting and nonroadway area lighting for public and private entities. The assets used in this business include the light fixtures ("luminaires"), the mast arms or brackets used to mount the luminaires on wood poles or other structures, poles made of aluminum, steel, and fiberglass, and wires. The taxpayer originally classified its street light assets as belonging in asset class 49.14 for depreciation purposes (meaning they were depreciable over 20 years), but through an application for change in accounting method filed in 1997, it proposed to reclassify the assets as having no class life (meaning by default they would be depreciable over seven years). The reclassification of street light assets placed in service before 1997 resulted in a negative adjustment to its 1997 taxable income of over \$18.6 million. 06,135. Also, consistent with that reclassification, it classified street light assets it placed in service in '97 as property without a class life. The Service argued that the street light assets really belonged in asset class 49.14 and therefore should be depreciated over 20 years. Before the Tax Court, the Service took the alternative position that the assets should be classified in asset class 00.3 with a recovery period of 15 years. The Tax Court held that the taxpayer's reclassification was proper. The street light assets were not in asset class 49.14 because they were "primarily used" to make light, not to distribute electricity. In addition, they did not belong in asset class 00.3 because they did not represent improvements to property. The street light assets were capable of being moved (and have in fact been moved), which suggests they are not permanent improvements to the land. The assets are designed and built to be moveable through a relatively quick and easy process, and they could be removed without being damaged. Even the poles were bolted to concrete foundations and not permanently affixed to the land. By default, then, the street light assets lacked a class life, so the taxpayer's requested seven-year recovery period was appropriate. *Pennsylvania Power & Light Co. v. Commissioner*, 135 T.C. No. 8 (July 28, 2010).

Section 168: Accelerated Cost Recovery System

2010 Small Business Act: 50% Bonus Depreciation Extended Through 2010. As was the case with respect to property acquired and placed in service in 2008 or 2009, depreciable tangible personal property and computer software acquired and first placed in service in 2010 is eligible for an additional up-front depreciation deduction equal to the 50% of the asset's adjusted basis after taking into account any § 179 election made with respect to the property. The regular depreciation deductions will then be computed based on whatever basis remains after the § 179 election and the 50 percent bonus. This bonus 50 percent allowance is also available for alternative minimum tax purposes. The 50 percent bonus does

not apply to intangibles amortized under § 197 (with the limited exception of computer software), or start-up expenses amortized under § 195. The bonus also does not apply to assets with a class life in excess of 20 years. *Section 168(k)*.

Section 170: Charitable Contributions and Gifts

You Can't Create a Conservation Easement Deduction Out of Thin Air. The taxpayer, through a single-member LLC, owns an 11-story apartment building on Fifth Avenue in New York City. The building is surrounded by other, taller buildings of uniform height on all sides. As a result, the taxpayer's building "is said to have the unfortunate appearance of a 'chipped tooth'—first, because it is the only shorter building in the immediate vicinity, and second, because its front section stands only eight stories high, whereas its back section stands eleven stories high. Thus, when viewed from the street, the building's shorter front section appears to be chipped or incomplete." In December, 2003, the taxpayer transferred his unused development rights ("i.e., the rights to further develop the property by, among other things, adding additional floors to the preexisting building on the property") to the National Architectural Trust, Inc., a charitable organization, and claimed a conservation easement deduction of \$21,850,000 for the diminution in value attributable to the conveyance. The Service disallowed the deduction and determined a deficiency of nearly \$4 million. The taxpayer petitioned the Tax Court, but the court upheld the deficiency. As the court observed, a qualified conservation easement requires "as its exclusive purpose, 'the preservation of an historically important land area or a certified historic structure'" (emphasis in original). The taxpayer's contribution of an "air rights" easement "did not oblige him to preserve—and he did not have the power to preserve—the structure of the existing building or the underlying land ... and any assurance in the Covenant that the structure would be preserved was redundant of restrictions imposed by New York City's Administrative Code and the Landmarks Preservation Commission." Moreover, the easement did not preserve a land area or a certified historic structure, as required for the deduction. Although the LLC may be disregarded for tax purposes, the court was clearly concerned that any restriction on the use of airspace above the apartment building was borne by the LLC and not by the taxpayer. *Herman v. Commissioner*, T.C. Memo. 2009-205 (September 14, 2009).

Taxpayer Saves Face in Saving Façades. The taxpayer owned two historic rowhouses in Washington, D.C. Through deeds executed in November, 2003, and January, 2004, she contributed conservation easements covering the façades of the properties to a charity that holds and enforces conservation easements on historic properties in the District. The deeds prohibited the taxpayer from making any material changes to the façades of the properties without the charity's consent, although the taxpayer could make improvements if the façades were damaged. An appraiser determined the value of the easements on the rowhouses were \$162,500 and \$93,000. In 2007, the taxpayer filed returns for 2003 and 2004, claiming conservation easement deductions of \$162,500 in 2003 and \$93,000 in 2004. The Service disallowed the deductions, so the taxpayer marched to Tax Court. The court concluded that the taxpayer contributed valid conservation easements even though the terms of the easements permitted future development of the properties, because the charity's authority to consent to changes to the façades was adequately limited by applicable laws and regulations. But while the taxpayer was entitled to deductions in the tax years at issue, the court concluded that the amounts deducted were excessive. The court determined that deductions of \$56,250 for 2003 and \$42,250 for 2004 were proper. *Simmons v. Commissioner*, T.C. Memo. 2009-208 (September 15, 2009).

Have Your Gift Card and a Deduction Too. Bake sales are so five minutes ago. These days, charities are raising funds through scrip, or gift cards to retail merchants. The taxpayer buys a \$50 gift card for use at Store by paying the money to Charity. Since Charity buys the card for \$40, it gets to keep the extra \$10. In this ruling, Charity gives the taxpayer the option to receive \$3 in cash in addition to the

gift card, but the taxpayer elects not to take the cash, preferring that it stay with Charity. The Service ruled that the \$3 rebate available to the taxpayer is not gross income to the taxpayer because it is a purchase price adjustment. In addition, the Service ruled that the taxpayer will be treated as making a \$3 donation to Charity, since the option to let the cash sit with Charity is voluntary. *Private Letter Ruling 200945022* (November 6, 2009).

Service Has Problems with Taxpayer's Premature Appraisal, But Tax Court Says to Get Over It. The taxpayer owned 250 acres, a portion of which abutted a state highway. The Ohio Turnpike Commission, seeking to construct an interchange at the intersection of the highway and one of its toll roads, offered the taxpayer \$93,800 as fair compensation for the 250 acres in April, 2001. Three months later, 40 acres of the taxpayer's property was rezoned commercial. Unhappy with the offer, the taxpayer obtained its own appraisal in July 2002. This one valued the property just a skosh higher: \$2.9 million. Without the taxpayer's knowledge, the Commission obtained a second appraisal in September, 2002, which valued the Property at \$600,000. Given the disparity, it's not surprising that negotiations broke down by January, 2003. The taxpayer told the Commission that if it wanted the property, it would have to acquire it through condemnation. So in March, 2003, the Commission commenced the required proceedings and deposited \$93,800 with the court. When the taxpayer learned of the September, 2002 appraisal, its counsel alleged that the Commission had committed fraud upon the court by depositing with the court \$93,800 instead of the \$600,000 it knew to be the fair market value of the property. The Commission took its hand out of the cookie jar long enough to sign a settlement agreement containing a final purchase price of \$950,000. On its 2003 return, the taxpayer treated the transaction as a bargain sale and claimed a charitable contribution deduction of \$641,000 (it listed the fair market value of the property as \$1,591,000). The Service disallowed the deduction, claiming the taxpayer did not comply with the substantiation requirements for the deduction by using an appraisal obtained more than 60 days in advance of the contribution and that, even if it did so comply, the taxpayer lacked the requisite donative intent for the deduction. The Tax Court upheld the taxpayer's claimed deduction. After thoroughly analyzing the three appraisals offered, the court concluded that the fair market value of the property was \$1,623,326. The court held that the substantiation requirements only required the taxpayer to provide sufficient information for the Service to evaluate the taxpayer's intended contribution. That the appraisal was obtained more than 60 days prior to the contribution was insubstantial. As to whether the taxpayer had donative intent, the court bought the testimony of the witness who claimed that the taxpayer had intended to donate at least some of the property to the Commission and had manifested an intent to execute a bargain sale transfer. Finally, the court concluded that the taxpayer miscalculated the amount of gain reportable from the transaction since the taxpayer did not properly apportion basis between the gift and sale portions of the transaction. *Consolidated Investors Group v. Commissioner*, T.C. Memo 2009-290 (December 16, 2009).

Substantial Compliance Only Saves You When There's Been Substantial Compliance. On their 2001 and 2002 returns, the taxpayers claimed charitable contribution deductions for donations of diagnostic and lab equipment to charitable organizations. The taxpayers attached Forms 8283 to substantiate their contributions, but the forms were incomplete. Only one of the three forms for the 2001 return included a separate appraisal report and a receipt from the charity, and only one of three forms for the 2002 return included both an appraisal and a receipt. When the Service disallowed the deductions for lack of substantiation, the taxpayers ran to Tax Court, claiming they should be entitled to the deductions because they were in "substantial compliance" with the substantiation requirements. The court acknowledged its own precedent holding that the substantiation requirements under § 170 require only substantial compliance rather than strict adherence. But in this case, said the court, there was not substantial compliance. It would be one thing if the taxpayers simply forgot to attach the written appraisals, but here they never obtained the appraisals. The information submitted did not describe the gifted property adequately and did not indicate their condition, and even the appraisal reports that were prepared used very generic terms like "good working condition" to describe the status of the donated

items. Nothing in the reports indicates the valuation method used by the expert in arriving at the value of the property. The taxpayers claimed they lost records that substantiated the contributions “while evacuating their house due to an approaching fire.” The court says that may have been reasonable cause for omitting the information, but “[i]f a taxpayer has reasonable cause, the regulations require an appropriate explanation to be attached to the appraisal summary. . . . Petitioners did not submit any such explanation with their Forms 8283.” As to the failure to obtain adequate written acknowledgments from the charities, the taxpayers argued that the Forms 8283 could also serve as written acknowledgments because they were signed by the donees. Of course, the problem with that argument is that the Forms 8283 do not contain a statement as to whether goods or services were provided by the donee in exchange, and this statement is required by § 170(f)(8)(B)(ii). The court rejected the taxpayers’ argument that a statement is only required when the charity actually furnishes goods or services to the donor. Accordingly, the Tax Court upheld the Service’s disallowance of the deductions. *Friedman v. Commissioner*, T.C. Memo. 2010-45 (March 11, 2010).

Tax Court Refuses to Apply Step Transaction Doctrine to Bargain Sales. The taxpayers were shareholders of an S corporation that makes and sells sheet metal products. In 2001, the corporation owned nearly 10,000 acres of vacant land near Taos, New Mexico, about one-quarter of which was known as the Taos Valley Overlook because of its views of the Rio Grande River and surrounding gorge. A small portion of the Overlook land was leased to the Bureau of Land Management for annual rents of one dollar. Starting in 1999, the Trust for Public Land, a charitable organization (TPL), expressed interest in acquiring the Overlook land from the corporation. TPL was unable to purchase the entire parcel at once because congressional appropriations for land acquisitions were too uncertain and variable, and the estimated value of the entire Overlook was about \$20 million. So in January, 2001, the corporation and TPL entered into an agreement under which the corporation gave TPL a series of options to purchase the Overlook acres in three easy installments of \$4 million in 2001, \$5 million in 2002, and \$5.5 million in 2003. The Trust for Public Land paid \$10,000 for the options, and this payment was to be credited against any subsequent purchase. TPL exercised the first option in 2001, acquiring land worth \$6.782 million. Before exercising the second option, the corporation and TPL amended their original agreement so as to allow TPL to purchase smaller chunks of the Overlook at fair market value, which it did. By the time it exercised the 2002 option, TPL acquired \$5.721 million of land for a reduced price of \$4.5 million. TPL and the corporation again agreed to let TPL purchase small chunks of the Overlook at fair market value, which it did. When it acquired the rest of the land through exercise of the 2003 option, it got \$3 million worth of land for a purchase price of just over \$1.6 million. The taxpayers took the position that the corporation’s sales to TPL in those years were bargain sales to charity, so they claimed charitable contribution deductions on their returns. The Service disallowed the deductions on the grounds that “under the step transaction doctrine [the corporation] should be treated as having sold to [TPL] in a single transaction on January 23, 2001, the effective date of the Option Agreement, the approximately 2,581 acres of the Taos Overlook, which the parties agree had a fair market value on that date of \$15 million, for which the Company received from the Trust total cash consideration of \$15 million, which is the total amount that the Trust paid to the Company in 2001, 2002, and 2003 to acquire all of the various phases of the Taos Overlook.” The Tax Court rejected this argument and allowed the charitable contribution deductions. The court analyzed all the variations of the step transaction doctrine in concluding that it did not apply. There was no “binding commitment” that required TPL to exercise all of the options, and it was not even certain at the time of the 2001 agreement that TPL would ever be in the position to exercise any of the options. The court also found no evidence that all of the installments were really prearranged parts of a single transaction intended from the beginning to reach a certain contemplated “end result.” Finally, the court determined that the separate installments were not so “interdependent” that exercising one option without exercising the others would have been fruitless. *Klauer v. Commissioner*, T.C. Memo 2010-65 (April 5, 2010).

Foreign Good Deeds Not Deductible. The taxpayer, though now a United States citizen, was born in a foreign country to parents who were devout Catholics. She was a young girl when guerrilla forces in her country initiated a military campaign. “When the guerrilla forces seized her hometown, [the taxpayer] witnessed over 400 of her fellow Catholics, including her uncle and other citizens of her hometown, being buried alive. [The taxpayer] managed to escape the massacre. Nonetheless, the guerrilla forces destroyed much of her hometown, including the Catholic church and seminary.” Following graduation from college in the United States, the taxpayer made several trips back to her native country to provide services and help rebuild churches. During one of her trips, she was detained by local authorities, who told her they were closely monitoring her activities. “Fearing for her life, [the taxpayer] devised a plan to disguise her contributions to Catholic churches in her native country. She would wire the money to the personal bank account of her mother’s cousin who lived in [the taxpayer’s] original hometown. The cousin then transferred the money to selected Catholic churches in that country. Other than her membership in a Catholic church, the cousin does not have any formal role with the Catholic seminary or any other Catholic institutions located in that country. [The taxpayer] wired to the cousin’s account \$8,025, \$4,000, \$5,000, and \$8,025 during the tax year 2006.” She claimed these amounts as charitable contributions on her 2006 return. She also deducted the cost of a plane ticket she bought that year to travel to her native country and provide services to the church. The Service disallowed these deductions, so she turned to the Tax Court for help. Unfortunately, the court had no choice but to side with the Service. The wire transfers were not made to a charitable organization organized in the United States. The taxpayer argued the ultimate beneficiary was the Roman Catholic Church, a qualified charity, but the court agreed with the Service that the payments were made for the benefit of foreign Catholic churches and not any charity organized in the United States. As for the airfare, the taxpayer argued it was an out-of-pocket expense incurred in rendering services for charity, but the court again stressed that the services had to be performed on behalf of a qualified United States organization. Furthermore, the taxpayer “did not render services in the foreign country under the direction of, or to or for the use of her local church or the local diocese. The record shows only that her priest at her local church had some awareness of her work in her native country.” *Anonymous v. Commissioner*, T.C. Memo 2010-87 (April 22, 2010).

A Façade Can’t Disguise a Mortgage. In 2003, the taxpayers, a married couple, granted a façade easement restricting the use of a single-family rowhouse located in a historic preservation district in Boston to the National Architectural Trust (NAT). NAT required that the taxpayers also donate a certain amount of cash (calculated as a percentage of the estimated value of the easement) for monitoring and administration of the easement, so the taxpayers contributed \$16,840 late in 2003. The taxpayers claimed a deduction of \$220,800 for the contribution of the easement, but they could only use \$103,377 of that amount in 2003, so the balance (\$117,423) carried over to 2004. They also deducted \$16,870 as a cash contribution on the 2003 return (don’t ask me where the extra \$30 came from). When the Service denied all of these deductions, the taxpayers filed suit in Tax Court. The Service moved for summary judgment on the whole matter. The Tax Court granted the motion as to the donation of the easement but not as to the cash contribution. The court agreed that the taxpayers did not meet all of the requirements for a deduction of the easement. Among other things, the regulations require that “at the time of the gift, the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that, at the time of the gift, is at least equal to the proportionate value that the perpetual conservation restriction bears to the value of the property as a whole.” The taxpayers could not meet this requirement because the rowhouse was encumbered by a mortgage. “Petitioners concede that ... the bank retained a ‘prior claim’ to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property. Moreover, petitioners do not dispute that the bank was entitled to those proceeds ‘in preference’ to NAT until the mortgage was satisfied and discharged. The right of NAT to its proportionate share of future proceeds was thus not guaranteed.” Seeing no issue of material fact here, the court granted summary judgment on this issue to the Service. The court would not grant summary

judgment with respect to the cash contribution, however. On that point, the Service's position is that the cash contribution was a conditional gift in violation of the regulations and that it was given as part of a quid pro quo, but the court agreed with the taxpayers that there is a genuine issue of material fact as to whether there was such an arrangement between the taxpayers and NAT. *Kaufman v. Commissioner*, 134 T.C. No. 9 (April 26, 2010).

Basing "After" Value on What the Service Has Okayed in the Past Not Enough. Back in 1997, the taxpayer purchased a townhouse within the Fort Greene Historic District of Brooklyn for \$255,000. In 2002, the National Architectural Trust sent a postcard to the taxpayer promoting an upcoming seminar on the possible tax benefits of façade conservation easements. The taxpayer and her accountant attended the seminar, and in 2004 the taxpayer donated a façade conservation easement to the NAT. As part of the deal, the NAT required the taxpayer to include a cash donation of ten percent of the easement's value. The property was encumbered, but the two banks holding mortgages on the townhouse consented to the donation. The taxpayer hired an appraiser from a list of valuation experts furnished by the NAT. The appraiser valued the townhouse at \$1,015,000 and the façade easement at \$115,000. The valuation was based in part on the range of easement values that the Service had previously found acceptable. The taxpayer sent a check to the NAT for \$9,275. On her 2004 return, the taxpayer claimed a \$115,000 charitable deduction for the façade easement. Because of the applicable percentage limitations in § 170, however, the taxpayer had to carry over part of this deduction to 2005 and 2006. The Service disallowed all the claimed deductions for 2004, 2005, and 2006, and also imposed § 6662(a) accuracy-related penalties for those years. The Service concluded that the appraisal submitted by the taxpayer failed to include all of the elements required under Regulation § 1.170A-13 and that therefore the taxpayer did not comply with the substantiation requirements. Among other things, that regulation requires a qualified appraisal and the completed Form 8283 to include a description of the property in sufficient detail for a person unfamiliar with the type of property to ascertain that the appraised property is the contributed property, a brief summary of the property's physical condition, the manner and date of acquisition, and the property's cost or other basis. Here, the Form 8283 did not include the manner or date of the property's acquisition or any information as to basis. The Tax Court agreed that the substantiation requirements were not met because of this flaw. Further, the court held that the valuation report was not a qualified appraisal because it determined the "after-easement value" of the property based on the range of values the Service has historically found acceptable and did not appear to consider qualitative factors about the property. According to the court, "the application of a percentage to the fair market value before conveyance of the facade easement, without explanation, cannot constitute a method of valuation as contemplated under" the regulation. The taxpayer argued that there was substantial compliance with the regulation, but the court held that the lack of a recognized methodology or specific basis for the appraiser's calculation of the after-easement value "is too significant for us to ignore under the guise of substantial compliance." The court did, however, abate the accuracy-related penalty on the grounds that the taxpayer was not a tax expert and had relied in good faith on her tax adviser in taking the position she did on her return. *Scheidelman v. Commissioner*, T.C. Memo 2010-151 (July 14, 2010).

Following Uniform Standards of Professional Appraisal Practice is Nice, But Not Required. The taxpayer, a limited partnership, acquired a parcel of property in New Orleans that contained historic structures. In 1997, the taxpayer donated a façade easement to one of the structures to a Louisiana nonprofit corporation (the Preservation Alliance of New Orleans). The taxpayer promised to keep the building façade in good repair and not to alter its appearance. The Preservation Alliance had the right to require the building owner to maintain the façade. The taxpayer claimed a charitable contribution deduction of about \$7.45 million, the claimed diminution in value of the structure on account of the servitude. The Service concluded that the deduction should only be \$1.15 million, so it assessed a deficiency and an accuracy-related penalty. The taxpayer marched to Tax Court, and the battle of the appraisers began. Not surprisingly, the experts went to extremes: the taxpayer's expert concluded that the value of the servitude was \$10 million, while the Service's expert determined that the value of the

servitude was zero since there was no diminution in value to the related structure. Part of the difference stemmed from the effect of the easement on contiguous property held by the taxpayer. Although the neighboring property was not legally subject to the easement, there were plans for the two properties to be consolidated into one, which would have the effect of broadening the scope of the easement. The taxpayer's appraiser took this into account, but the Service's appraiser did not. The taxpayer tried to block the testimony offered by the Service's expert, claiming that he was unqualified to opine on façade donations and because his report did not conform to the Uniform Standards of Professional Appraisal Practice (USPAP). The court held that no special qualifications were required to opine on façade donations since, at their heart, they are no different from any other restriction on property which qualified appraisers routinely encounter in their work. As to the USPAP, while the court conceded adherence to those standards is evidence that an appraiser's report is reliable, "a noncompliant valuation report is not per se unreliable. Full compliance with professional standards is not the sole measure of an expert's reliability." In fact, the court found the analysis of the Service's expert to be more persuasive, concluding that the value of the servitude was about \$1.8 million. In reaching this conclusion, the court determined that the pending consolidation of the subject property and the neighboring building was not to be considered in determining the diminution in value because the consolidation was not in effect at the time of the contribution. Because the taxpayer overstated the value of the contribution on its 1997 return by more than 415%, the court agreed with the Service that the taxpayer made a gross valuation misstatement, so the assessed penalty was upheld. The Fifth Circuit vacated the Tax Court's determination of the diminution in value and remanded the case back to the Tax Court for another determination. The Fifth Circuit concluded that the Tax Court "should have considered the easement's effect on fair market value in the light of the imminent legal and functional consolidation of the two buildings. ... [The Tax Court] was correct that, because, on the day of donation, the condominium regime was not yet in effect, a successor could have purchased the [neighboring] building separately that day and would not have been bound by the easement; but, *as a matter of valuation*, the ... court erred by not considering the effect on market value of the buildings' pending combination. To that end, a hypothetical buyer would have contemplated the pending combination of the buildings in deciding on a purchase price. Along that line, both buildings were then owned by [the taxpayer]. Regarding the *legal* combination of the buildings (*i.e.*, the condominium regime), it is implausible that a hypothetical buyer of the [neighboring] building ... would have no knowledge of the plan to combine the buildings into a single piece of property via a condominium regime imposed the next day." But the Fifth Circuit upheld the Tax Court's determination that the Service's appraiser could offer expert testimony on value even though the appraisal did not formally comply with the USPAP. As for the penalty, the Fifth Circuit indicated that its review of that issue will depend on the Tax Court's recomputation of the proper deduction. *Whitehouse Hotel Ltd. Partnership v. Commissioner* (5th Cir., August 10, 2010).

Section 172: Net Operating Loss Deduction

2009 Homeownership Act: Pick a Number, Any Number, As Long As It's Between Two and Six. The election to carry a net operating loss back three, four, or five years (instead of the normal two years) has been expanded to apply to all taxpayers with NOLs from a taxable year ending in 2008 or 2009. A taxpayer may make this election with respect to an NOL from either 2008 or 2009, but not both. Only taxpayers that qualify as "eligible small businesses" may make an election to carry an NOL from 2008 back five years in full; in all other cases, taxpayers seeking a five-year carryback may only apply that NOL to 50% of the taxpayer's taxable income that year. Thus, taxpayers other than eligible small businesses are subject to this 50% limitation for five-year carrybacks of 2008 NOLs, and all taxpayers (including eligible small businesses) are subject to the 50% limitation for five-year carrybacks of 2009 NOLs. An eligible small business is a sole proprietorship, corporation or partnership with average annual gross receipts of not more than \$15 million over the prior three years. *Section 172(b)(1)(H)*.

Section 179: Election to Expense Certain Depreciable Business Assets

2010 HIRE Act: Due to Popular (?) Demand, the Uber-Bonus Continues. As was the case under prior legislation for 2008 and 2009, taxpayers in 2010 may expense the first \$250,000 (not \$125,000, as was the case for 2007) of depreciable property purchased during the taxable year for use in the active conduct of a trade or business activity, even though normal rules would require depreciation of such costs. This “bonus first-year depreciation” remains elective—a taxpayer need not claim the bonus depreciation if he or she does not want it (but in most cases, of course, he or she would). If the total amount of qualifying property purchased in any year exceeds \$800,000, however, the \$250,000 bonus is reduced dollar for dollar. (For 2007, the threshold for reducing the § 179 dollar limitation was \$500,000.) Thus, if a taxpayer purchases qualifying property in 2010 for \$900,000, only \$150,000 of qualifying property can be expensed under § 179. The \$250,000 limitation will revert to \$25,000 in 2011, and the threshold for reducing the dollar limitation will shrink to \$200,000 in 2011. (Well, until you read the next item anyway.) *Section 179(b)(1) – (2).*

2010 Small Business Act: Our Addiction to Expensing is Spiraling. Apparently a \$250,000 ceiling is too restrictive. Now, taxpayers may expense the first \$500,000 (!) of depreciable property purchased during 2010 or 2011 for use in the active conduct of a trade or business activity. There is still a dollar-for-dollar reduction of this maximum if the total amount of qualifying property purchased in 2010 or 2011 exceeds a threshold amount, but that threshold is now \$2,000,000. Thus, if a taxpayer purchases qualifying property in 2010 for \$2,300,000, only \$200,000 of qualifying property can be expensed under § 179. The \$500,000 limitation will revert to \$25,000 in 2012, and at that time the threshold for reducing the dollar limitation will shrink to \$200,000. (Yeah, right.) *Section 179(b)(1) – (2).*

Section 183: Activities Not Engaged in for Profit

Taxpayers Weren't Horsing Around, So Tax Court Allowed Deductions. The taxpayers, a married couple, maintain over 40 horses on their property. They eventually hoped to create a self-perpetuating herd of purebred Arabian horses that would increase in value over time and become profitable. The taxpayers did almost all of the grunt work themselves. From 1993 to 2002, the husband worked full time as a land-use planner for two counties, though he spent the early weekday mornings, late weekday evenings, and weekend on the horse activity. The wife typically spent her entire work week on the horse activity, as she was otherwise unemployed. Over that time, the horse activity racked up over \$400,000 in losses. When they finally got around to filing returns for those years, they claimed net operating loss deductions from this activity. The Service determined that the horse activity was a hobby, so it disallowed the net operating losses. But the Tax Court held that the couple had the actual and honest objective or making a profit, so it ruled that § 183 did not apply to the taxpayers. The court cited several facts that were helpful in reaching its conclusion: they kept adequate records; they initiated a lawsuit to obtain clear title of a horse for breeding purposes; they expended a lot of time and effort conducting the activity; they were of modest financial status and did not have substantial income from other sources; and they did not ride the horses as a hobby and did not otherwise use them for entertainment. *Helmick v. Commissioner*, T.C. Memo. 2009-220 (September 22, 2009).

Section 195: Start-Up Expenditures

2010 Small Business Act: More Start-Up Expenditures Deductible Up Front. Taxpayers launching a new trade or business activity must normally capitalize start-up expenditures (costs that would have been deductible as business expenses had the taxpayer already been carrying on the business

activity) and amortize them over 15 years. Section 195 permits taxpayers an immediate deduction for up to \$5,000 of start-up expenditures, however, provided the total start-up expenditures do not exceed \$50,000. For every dollar that start-up expenditures exceed this \$50,000 threshold, the immediate deduction amount is reduced by one dollar. Thus, for example, a taxpayer with \$53,000 of start-up expenditures may immediately deduct the first \$2,000 of such costs and then amortize the remaining \$51,000 over 15 years. For taxable years beginning in 2010 only, the up-front deduction is increased to \$10,000 and the phase-out threshold is increased to \$60,000. Thus, a taxpayer with \$53,000 of start-up expenditures in 2010 can immediately deduct \$10,000 of the costs and then amortize the remaining \$43,000 over 15 years. *Section 195(b)(3)*.

Section 197: Amortization of Goodwill and Certain Other Intangibles

Noncompete In Connection With Redemption Amortizable Over 15 Years. The taxpayer, an S corporation, redeemed all of the stock of a minority shareholder and employee. In addition to paying the shareholder-employee for his 23% interest, the taxpayer also paid the shareholder-employee to enter into a one-year covenant not to compete. The taxpayer deducted the cost of the covenant not to compete over its one-year term, but the Service said the cost had to be amortized over 15 years under § 197(d)(1)(E). That provision requires 15-year amortization if the covenant not to compete was “entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof.” The taxpayer argued that the redemption of a 23% interest is not the acquisition of a substantial portion of a trade or business, so 15-year amortization need not apply. To buttress its argument, the taxpayer cited a case in which the Tax Court held that a redemption of 75% of a corporation’s stock qualified as the indirect acquisition of an interest in a trade or business for purposes of § 197. Apparently the taxpayer’s logic is that an acquisition of a 23% interest is not “substantial” in comparison with the acquisition of a 75% interest. The court didn’t buy this argument, saying the taxpayer “aggressively misreads” the holding of the prior case. The court observed that the only hint as to the meaning of “substantial” in the § 197 context is found in the anti-churning rules of §197(f)(9), and those are triggered in the case of a 20% interest. If that’s substantial, reasons the court, then the 23% interest at issue in this case must also be substantial. Accordingly, the court held that the payment must be amortized over 15 years. *Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76 (April 15, 2010).

Section 213: Medical, Dental, Etc., Expenses

Taxpayer Trying to Milk Deduction for Infant Formula. Before the birth of her child, the taxpayer had a physician-advised double mastectomy to address undisclosed medical conditions. Consequently, the taxpayer was unable to breastfeed her child and had to purchase infant formula to meet the baby’s nutritional needs. She asked for a ruling that the cost of the infant formula was deductible as a medical expense, but the Service denied the request. The Service ruled that the formula represents food that the infant would normally consume and not a medical expense. A 1955 revenue ruling states that the cost of special foods and drinks can qualify as deductible medical expenses where they are: (1) prescribed by a physician for alleviation of a specific illness, (2) in addition to the taxpayer’s normal diet, and (3) not in any way a part of the nutritional needs of the patient. Fortunately, the taxpayer’s child is healthy and the formula represents normal food. Unfortunately, that means the taxpayer flunks the three-part test from the ruling. The ruling is consistent with a 2002 ruling that individuals participating in a weight loss program can't deduct the cost of purchasing reduced-calorie diet food because the foods are substitutes for the food the individual would normally consume to satisfy nutritional requirements. *Private Letter Ruling 200941003* (October 9, 2009).

Healthy Male Can't Deduct In Vitro Fertilization Costs as Medical Expenses. In 2004, the taxpayer entered into an arrangement with a medical clinic whereby an anonymous egg donor donated eggs that were fertilized with the taxpayer's sperm and then "transferred to a gestational carrier" (that would be a woman) through in vitro fertilization (IVF). The "carrier" gave birth to the taxpayer's child in 2005. It worked so well the first time, the taxpayer repeated the process later in 2005 with a different "carrier," and she gave birth in 2006. Both the donor and the "carriers" were unrelated to the taxpayer. The taxpayer incurred many expenses in connection with these births, including legal fees, a fee to the donor, fees to the "carriers," fees to the IVF clinic, and prescription drugs for the "carriers." The costs totaled \$50,965 in 2004, and \$37,654.35 in 2005. The taxpayer claimed the lion's share of these costs as medical expenses on his 2004 and 2005 returns, and since they exceeded 7.5 percent of his adjusted gross income each year, he claimed deductions on the returns. The Service disallowed the deductions in their entirety, determining that while amounts paid to mitigate infertility may be medical expenses, the costs here were not for "medical care" because the taxpayer "had no physical or mental defect or illness which prohibited him from procreating naturally." The taxpayer challenged this determination before the Tax Court, claiming that the Service allowed a medical expense deduction for costs related to an egg donor in a 2003 private ruling. The Tax Court agreed with the Service. It held that none of the taxpayer's costs are for medical care because none were incurred primarily to prevent or alleviate a physical or mental defect or illness. "In other words, petitioner had no medical condition or defect, such as, for example, infertility, that required treatment or mitigation through IVF procedures. We therefore need not answer lurking questions as to whether (and, if so, to what extent) expenditures for IVF procedures and associated costs (e.g., a taxpayer's legal fees and fees paid to, or on behalf of, a surrogate or gestational carrier) would be deductible in the presence of an underlying medical condition." Moreover, said the court, the costs are not deductible as medical expenses "because they did not affect a structure of function of [the taxpayer's] body." On appeal, the First Circuit affirmed. It reasoned that the expenses paid by the taxpayer were not for treating his own underlying medical condition; after all, he was not infertile and had fathered other children by natural processes. Furthermore, none of the procedures affected the structure or function of his own body; instead, they affected the bodies of the gestational carriers who weren't his dependents. *Magdalin v. Commissioner* (1st Cir., December 17, 2009).

Some But Not All Costs Associated With Sex Reassignment Deductible as Medical Expenses. In a 69-page opinion with 70 pages of concurring and dissenting opinions, the Tax Court has held (14-5) that hormone therapy and sexual reassignment surgery costs are deductible medical expenses but that breast augmentation surgery costs are not deductible. The taxpayer was born a genetic male, but by 1997 was diagnosed with gender identity disorder (GID), a medically recognized condition "in which an individual experiences persistent psychological discomfort concerning his or her anatomical gender." The taxpayer had a number of treatment options, including taking feminizing hormones, living as a female in public, or, after living for at least one year as a female, surgical modification of the genitals and, sometimes, breasts to resemble those of a female. The taxpayer started taking hormones in 1997 and, after plastic surgery to feminize facial features, the taxpayer started living in public as a female in 2000. In 2001, she underwent sex reassignment surgery, including breast augmentation. The taxpayer sought to deduct the cost of the surgeries, transportation and related expenses, and feminizing hormones as medical expenses on her 2001 return. The Service disallowed the deduction, so the taxpayer petitioned the Tax Court. The court held that GID is a "disease" within the meaning of § 213(d)(1)(A) and that the taxpayer's hormone therapy and sex reassignment surgery treated this disease. The sex reassignment surgery was not, according to the majority, cosmetic surgery, so that cost and the cost of the hormones were deductible. The breast augmentation procedure, on the other hand, served only to improve her appearance, so the court held this expense was nondeductible as cosmetic surgery. The court concluded that the taxpayer could not prove how the breast augmentation surgery meaningfully promoted the function of the body or treated any disease. The dissenters would have denied the deductions entirely because § 213(d)(9)(A) disallows deductions for cosmetic surgery and "similar procedures." They see sex reassignment surgery as a similar procedure. Furthermore, the exception in § 213(d)(9)(B) only

applies to procedures that “prevent” or “treat” a disease. The dissenters reason that the procedure does not “prevent” GID and does not “treat” it (it does not cure the disease). Although § 213(a) generally allows a deduction for costs that “mitigate” a disease, this word is missing from the exception in § 213(d)(9)(B), and that makes all the difference to the dissenters. *O'Donnabhain v. Commissioner*, 134 T.C. No. 4 (February 2, 2010).

2010 Health Care Act: 10% Threshold to Replace 7.5% Threshold in 2013. Starting in 2013, the deduction for uncompensated medical expenses will be allowed to the extent such costs exceed 10% of the taxpayer’s adjusted gross income. Current law, of course, allows a deduction to the extent uncompensated medical expenses exceed 7.5% of adjusted gross income. A special rule applicable for 2013, 2014, 2015, and 2016 retains the old 7.5% threshold where the taxpayer or the taxpayer’s spouse is age 65 or over by the end of the taxable year. *Section 213(a), (f)*.

Section 263: Capital Expenditures

Costs Incurred in Defending Cy Pres Lawsuits Must be Capitalized. The taxpayer provides healthcare insurance coverage to its members as a licensee of Blue Cross. In a series of transactions from 1993 through 1997, the taxpayer merged with the largest Blue Cross plans in Connecticut, Kentucky, and Ohio. The attorneys general in each state brought a *cy pres* action against the taxpayer, arguing that because the Blue Cross plans in each state were charitable entities, the assets of each plan were “impressed with a charitable trust.” They sought to have the assets from each plan stripped from the taxpayer and redirected to a similar charitable purpose. To settle the claims in all three matters, the taxpayer made payments totaling nearly \$114 million in 1999. On its 1999 return, the taxpayer deducted the settlement payment and the roughly \$820,000 it incurred in legal fees with respect to the lawsuits as business expenses. The Service disallowed the deductions, concluding these were capital expenditures. The Tax Court upheld the Service’s position, holding that the settlement and legal fees were costs incurred in litigating title to property. The *cy pres* actions basically challenged the taxpayer’s right to hold the assets acquired through the mergers, so the payments were incurred to resolve disputes over the ownership of assets. Applying the “origin of the claim” doctrine, the Seventh Circuit affirmed. The taxpayer acquired companies that were held in charitable trusts, the court noted, and the attorneys general were trying to strip the taxpayer of its equitable ownership represented by its right to use the acquired assets for profit. That meant the litigation expenses were incurred to defend ownership of a capital asset and thus must be added to the taxpayer’s basis in the asset and not currently deducted. *Wellpoint, Inc. v. Commissioner* (7th Cir., March 23, 2010).

Section 263A: Capitalization and Inclusion in Inventory Costs of Certain Expenses

Royalty Payments to Third Parties Need Not Be Capitalized. The taxpayer sells kitchen tools labeled with trademarks licensed from third parties. The taxpayer pays royalties to these parties from the sales of these products. On its 2003 tax return, the taxpayer deducted the royalty payments as ordinary and necessary business expenses, but the Service issued a notice of deficiency after concluding that the royalties had to be capitalized and added to the taxpayer’s inventory costs. The Tax Court agreed with the Service, but on appeal the Second Circuit reversed. As the court explained, “We hold that where, as here, a producer’s royalty payments (1) are calculated as a percentage of sales revenue from inventory and (2) are incurred only upon the sale of that inventory, they are immediately deductible as a matter of law because they are not ‘properly allocable to property produced’ within the meaning of 26 C.F.R. § 1.263A-1(e). We therefore REVERSE the decision below.” According to the court, the Tax Court confused the license agreements with the royalty costs. The taxpayer’s royalties were not “incurred by reason of” production activities, and did not “directly benefit” such activities. “We hold that under the plain text of

the regulation it is the costs, and not the contracts pursuant to which those costs are paid, that must be a but-for cause of the taxpayer's production activities in order for the costs to be properly allocable to those activities and subject to the capitalization requirement.” *Robinson Knife Manufacturing Co. Inc. v. Commissioner* (2d Cir. March 19, 2010).

Section 448: Limitation on Use of Cash Method of Accounting

Survey Says! Surveying is Engineering. The taxpayer, a corporation, does one thing and one thing only: land surveying in Tennessee. It does not employ any licensed engineers, is not associated with any firm that employs licensed engineers, and does not provide any services that State law requires to be performed only by a licensed engineer (that’s important later). A temporary regulation, Regulation § 1.448-1T(e)(4)(i), provides that “engineering” includes surveying and mapping. Using this regulation, the Service determined that the taxpayer’s land surveying meant the taxpayer performed services in the field of engineering and that, therefore, the taxpayer is a qualified personal service corporation subject to a flat 35% federal income tax rate. The taxpayer went to Tax Court to argue that the temporary regulation is invalid or, in the alternative, means only that surveying and mapping services *performed by an engineer* would qualify as services in the qualifying field of engineering. Since the taxpayer has no engineers, this interpretation would mean the taxpayer is not a qualified personal service corporation. The taxpayer further argued that land surveying in Tennessee can be performed only by a licensed land surveyor and that it is not licensed to perform any activity which Tennessee law requires to be performed by a licensed engineer. Alas, the Tax Court held that application of the 35% tax rate was proper here because the taxpayer is a qualified personal service corporation. The court upheld the regulation as consistent with the legislative history and with the plain meaning of the term “civil engineering” (which includes surveying). The regulation, therefore, is not arbitrary, capricious, or manifestly contrary to the statute. *Kraatz & Craig Surveying Inc. v. Commissioner*, 134 T.C. No. 8 (April 13, 2010).

Section 451: General Rule for Taxable Year of Inclusion

It’s Hard to Receive a Check When the Office is Closed. The taxpayer was fired after his employer was acquired by an outside company. The taxpayer filed the paperwork required to request a final distribution from his former employer’s deferred compensation plan. On December 31, Year 1, an employee of the new company telephoned the taxpayer and advised him that the disbursement check was available for pick up at the company’s office in “City A.” Well, the City A office was closed all day on December 31, Year 1, so the taxpayer picked up the check on January 2, Year 2. The Service ruled that the taxpayer was not in constructive receipt of the check in Year 1 because it was impossible for the taxpayer to take possession of the check or otherwise obtain any economic benefit from the check. The Service also ruled that the taxpayer may report the disbursement check as income in Year 2, the year of actual receipt. *Private Letter Ruling 200945005* (November 6, 2009).

Restrictions on Stock Did Not Prevent Inclusion in Gross Income. When Ernst & Young spun off its information-technology consulting group in 2000, consulting partners moving with the spin-off received shares of the new entity (Capgemini) in exchange for their partnership interests in E&Y. Everyone expected the Capgemini shares to appreciate in value, so they wanted to recognize the gain from this swap in 2000. That way, the future (and hopefully substantial) appreciation would be capital gain. But if the partners all got their grubby paws on the stock in 2000, they could bail and leave Capgemini high and dry. So everyone agreed that the shares received by a partner would be restricted for about five years; if a partner left or got fired for cause during this period, some or all of the shares would be forfeited. The taxpayer, one of the partners, participated in this deal. In May of 2000, he executed the requisite documents and received almost 11,000 shares of Capgemini in exchange for his interest in E&Y.

On his timely filed his income tax return for 2000, the taxpayer reported the value of all the shares as taxable income. Well, as you would have guessed, Capgemini did not take off as planned. By the end of 2002, the stock had lost about 5/6 of its value. In December, 2002, the taxpayer lost his job as part of a workforce reduction. Although his departure was within the five-year probation period, Capgemini lifted all restrictions on his shares. In 2003, the taxpayer and his spouse then filed an amended return for 2000, taking the position that they should only be taxed on the value of the stock that was sold to pay taxes. They contended that they should not have been taxed on the additional shares in 2000, but instead in late 2002 when the restrictions were lifted because the taxpayer lacked control over those shares. The district court agreed with the Service that the parties intended to recognize the value of all the Capgemini stock as taxable income in 2000, and that the parties bargained at arm's-length for (and received) "real economic benefit" from treating all the Capgemini stock as received in 2000 for federal income tax purposes. On appeal to the Fourth Circuit, the taxpayer argued that because he never "received" the unsold Capgemini shares in 2000, he, as a cash method taxpayer, should not have included the value of those shares in gross income. But the Fourth Circuit, applying an "economic reality test" that examines the intent of the parties and the economic substance of the transaction, held that the taxpayer properly included the value of the entire block of stock in gross income for 2000. It was clear to the court that the parties wanted the consulting partners to be taxed immediately on all of the shares they received in 2000, and by subject the whole block of stock to tax in 2000, the holding period for capital gains treatment could start right away and the amount of ordinary income would be minimized. The taxpayer also argued that the unsold Capgemini stock was not includible under § 83 because they were subject to a substantial risk of forfeiture, but the court rejected this position. Section 83 applies only where property is transferred in connection with the performance of services, and in this case the swap of a partnership interest for Capgemini stock was unrelated to the performance of services. As the court concluded, nothing in § 451 or elsewhere in the Code "permits a taxpayer to whipsaw the Government and the other parties to the transaction by unilaterally altering the agreed tax treatment, which has economic substance and reflects his intent, after the fact when the winds of change foment delayed seller's remorse." On similar facts, the Seventh Circuit reached the same result in a 2009 case, so now two federal appellate courts have held taxpayers to the terms of their transactions. *United States v. Bergbauer* (4th Cir., April 16, 2010).

Does This Sound Familiar? Here's the story of another former E&Y consulting partner's sale of his partnership interest in exchange for CapGemini stock. The facts are basically the same as in the *Bergbauer* case above. This time, the federal district court focused on whether the taxpayer was in constructive receipt of the entire block of stock in 2000. Although the sale restriction prohibited the taxpayer from selling most of his shares for up to five years, he still exercised substantial control over all of the shares in 2000, as he alone stood to gain or lose money based on the stock's performance. He received the dividends paid on the shares and had the right to direct the voting of the shares. On top of that, he knowingly agreed to the sale restriction, the forfeiture provision, and other terms of the deal. This constitutes enough control over the shares to be deemed to be in constructive receipt of them. Thus the taxpayer was stuck with the gain originally reported on the 2000 return. *United States v. Fort* (D.C. Ga., May 20, 2010).

Section 469: Passive Activity Losses and Credits Limited

Managing Member of an LLC Not Treated as a Limited Partner. The taxpayer was the managing member and a one-third owner of an LLC that operated a golf course, restaurant, and country club facility. In each of the taxable years at issue (2001, 2002, and 2003), the taxpayer devoted at least 400 hours to the activity, but the taxpayer's share of the losses in each of those years ranged from about \$1.9 million to \$2.1 million. The Service determined that this was a passive activity of the taxpayer and thus disallowed the claimed losses from each year. Sure, the activity was a "significant participation activity" of the taxpayer, but the Service contended that LLC members are limited partners, and under §

469(h)(2) limited partners cannot use the “significant participation activity” test for material participation. The Tax Court held that a managing member of an LLC is not a limited partner for purposes of § 469(h)(2), so this limitation did not apply. This was especially true here, as the taxpayer “managed the day-to-day operations of [the LLC], functioning just as a general partner would function in a limited partnership.” Combined with the taxpayer’s other “significant participation activity” (involvement in an S corporation), the taxpayer easily met the 500-hour threshold for material participation. Accordingly, the losses were allowed. *Newell v. Commissioner*, T.C. Memo. 2010-23 (February 16, 2010).

Service Acquiesces in Decision That LLC Member is Not Limited Partner. The taxpayer was a 99% member and the sole manager of an LLC (his S corporation owned the other 1% interest in the LLC). When the taxpayer claimed losses of about \$1 million from the LLC in each of 2002 and 2003, the Service disallowed them on the grounds that the LLC was a passive activity of the taxpayer. Whether the taxpayer materially participates in the LLC depends on whether the taxpayer’s interest is a limited partner interest. If so, he does not materially participate (since he did not spend 500 hours per year in the activity and did not materially participate for five of the ten prior years). But if his LLC interest is not a limited partner interest, he does materially participate (since he was the only person who participated in the activity). The Service argued that the LLC interest was a limited partnership interest because the entity was taxed as a partnership and the taxpayer had limited liability, while the taxpayer argued that he cannot be a limited partner since the LLC is not a limited partnership (he also argued that even if the LLC is a limited partnership, his personal management and control effectively makes him more like a general partner than a limited partner). The Court of Federal Claims held that both the statute and the regulations apply more rigorous tests for material participation only in the case of those who actually hold limited partner interests, and not also to those who hold interests akin to those of limited partners. As the court observed, § 469(h)(2) states that “[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates” (emphasis added). Thus for this provision even to apply, the taxpayer must actually be a limited partner. Moreover, said the court, the taxpayer here was the sole manager of the entity, so even if § 469(h)(2) applied it would not disallow the taxpayer’s losses here since he was more like a general partner. The court rejected the Service’s argument that all interests in limited liability entities should be treated as interests in limited partnerships, concluding that “the surrounding statutory and regulatory framework does not support a ‘dividing line between the two types of [partnership] interests [based on] limited liability,’ as defendant suggests, but rather a dividing line based on participation. Defendant loses sight of what the Treasury ... drafted § 1.469-5T to define—namely, what constitutes ‘material participation’ in an activity. Deciding whether a taxpayer materially participated in an activity is but one step in the ultimate determination of whether the taxpayer was involved in a ‘passive activity.’ These terms—‘material participation’ and ‘passive activity’—indicate that Congress was primarily concerned with the taxpayer’s level of involvement in the activity in question. If Congress desired a test that turned on a taxpayer’s level of liability, it surely would have included the word ‘liability’ somewhere in the statute. However, as defendant’s counsel admitted at oral argument, the word ‘liability’ does not appear in § 469.” The court held that the legislative history to § 469 did not support the Service’s position either. Accordingly, the taxpayer’s interest was not a limited partner interest. The Service has acquiesced in this case in result only. *Thompson v. United States* (Fed. Cl. 2009), *acquiesced in result only*, Action on Decision No. 06-211 (April 5, 2010).

Taxpayer Did Not Materially Participate in Cabin Rental Activity. The taxpayer owned a three-bedroom cabin home in California. In 2004, he contracted with a property management company to rent the cabin that year. The taxpayer agreed to pay the company a 35% commission on all rental income received. While the company was responsible for arranging housekeeping and linens for renters, the taxpayer was on the hook to keeping the property in a safe and aesthetic condition, paying all utilities, having the property deep-cleaned twice a year, and providing linens. The cabin was rented three times during 2004 for a total rental period of 12 days and 9 nights. The taxpayer and his family visited the

cabin eight times that year for a total of about 27 days and 19 nights. On his 2004 return, the taxpayer deducted \$20,258 of expenses relating to the rental of the cabin on his Schedule E. The Service disallowed this entire deduction, so the taxpayer marched to Tax Court. The court initially determined that the cabin was not a “rental activity” under § 469(j)(8) because the average rental period did not exceed seven days. That meant the taxpayer’s only hope for claiming the loss was to show that he materially participated in the activity. As the court observed, he could demonstrate material participation by showing either that: (1) no other individual’s participation exceeded his own participation in 2004; or (2) he participated in the activity for more than 100 hours in 2004. There was little evidence to show the taxpayer spent more than 100 hours with the rental of the cabin, and the taxpayer did not establish that no other individual’s participation exceeded his own, as the management company was responsible for advertising, showing, and renting the property, and a cleaning service cleaned the property after each rental. Thus, there was no material participation meaning the loss was disallowed under § 469. To add salt to the wound, the court also held that the cabin was a “residence” for purposes of § 280A in 2004. Because the cabin was rented for less than 15 days during the year, the taxpayer did not have to include any rental income on his 2004 tax return, but he also could not deduct any expenses related to the cabin. The court clarified that the taxpayer could, however, deduct the mortgage interest and taxes attributable to the cabin on his Schedule A. *Akers v. Commissioner*, T.C. Memo. 2010-85 (April 21, 2010).

Section 482: Allocation of Income and Deductions Among Taxpayers

“Never Mind,” Says the Ninth Circuit. The taxpayer develops, makes, markets and sells field programmable logic devices, integrated circuit devices, and other development software systems. The taxpayer was the parent corporation of an affiliated group that included Xilinx Ireland (XI), an Irish unlimited liability company owned by the taxpayer indirectly through two other Irish subsidiaries. XI made, marketed and sold software systems to customers in Europe. The taxpayer and XI were parties to a “Technology Cost and Risk Sharing Agreement” that required each party to pay a percentage of their combined research and development costs in proportion to their respective anticipated benefits from newly developed technology. During the years at issue, the taxpayer offered incentive stock options, nonstatutory stock options, and employee stock purchase plan purchase rights as compensation. The options had an exercise price equal to the stock’s market value on the grant date, and the exercise price for the ESPP purchase rights was 85% of the stock’s market price. Pursuant to GAAP, the taxpayer did not include any amount related to the issuance of employee stock options to (or exercise of stock options by) its employees who performed research and development as part of its research and development costs for purposes of the cost sharing agreement with XI. That meant the taxpayer could claim the entire deduction for those expenses, as they were not subject to the cost sharing agreement. The Service issued a deficiency notice to the taxpayer, claiming that the excess of stock’s market price on the exercise date over the exercise price (or, alternatively, the grant date value) should have been included as a research and development cost for cost sharing purposes. The taxpayer found a friend in the Tax Court, which held in favor of the taxpayer. The taxpayer’s allocation of costs met the “arms’-length” standard of the regulations, concluded the court, because unrelated parties would not have shared the spread or the grant date value. The Service’s requirement to share the costs was therefore arbitrary and capricious, said the lower court. The Service appealed. In a 2009 opinion, the Ninth Circuit observed that two conflicting regulations applied here. One, Regulation § 1.482-1(b)(1), says that the true taxable income of controlled parties is to be calculated based on how parties operating at arm’s length would act. That regulation supports the lower court’s conclusion. But the other regulation, Regulation § 1.482-7(d)(1) (which is now obsolete, by the way), says that controlled participants in cost sharing arrangements for the development of intangible property must include *all* costs in the pool of those to be shared proportionally. That regulation supports the Service’s position. So which regulation wins out? The Ninth Circuit said the second one wins because it is more specific. Although this means the Service wins, the court was less convinced that the taxpayer should face an accuracy-related penalty in this case. Given the Service

promulgated new regulations clarifying the issue by explicitly including employee stock options as costs to be shared, there's a good argument that the prior guidance was sufficiently misleading so as to make the taxpayer's position reasonable enough to avoid a penalty. It remanded the case to the Tax Court to consider this issue further. But then, in a mysterious one-sentence order issued in January, 2010, the Ninth Circuit withdrew its opinion without comment. That set the stage for this decision, in which the court affirmed the Tax Court. According to the new opinion, the more specific rule need not take precedence where Congressional intent appears to favor the more general rule. That's the case here, according to the new-and-improved Ninth Circuit, because Treasury's technical explanations of the United States's income tax treaties with several European countries (including Ireland) all endorse the arm's length standard. *Xilinx v. Commissioner* (9th Cir., January 13, 2010).

Section 691: Recipients of Income in Respect of Decedents

Assignment of Decedent's IRA to Charity Does Not Trigger Income to the Estate. The decedent forgot to name a beneficiary of his IRA before he died, making his estate the beneficiary under applicable state law. The decedent's will tosses everything from the estate into a trust that makes a number of specific bequests and leaves the rest to various charities. Having other assets with which to satisfy the specific bequests, the estate intends to transfer the entire IRA to one of the charities designated as a residual beneficiary. But before doing so, the estate wants a ruling that the transfer will not cause the estate to recognize gross income under § 691(a)(2). The Service gave them the ruling they wanted, explaining that only the charity will include the amounts of income in respect of a decedent from the IRA in gross income upon a distribution from the IRA. The ruling expresses no opinion as to the exact consequences to the charity or even as to whether the charity is a § 501(c)(3) organization. *Private Letter Ruling 201013033* (April 2, 2010).

Section 705: Determination of Basis of Partner's Interest

No Shirt, No Shoes, No Basis, No Loss. The taxpayers, a married couple, held a limited partnership interest in an agricultural venture from 1986 through 1998. They initially contributed \$26,000 to the partnership, and assumed about \$41,600 in partnership liabilities. In 1986, the partnership claimed a net loss of about \$34 million (\$32 million from farming expenses). The taxpayers' share of the loss was \$69,380, and they deducted this amount in their 1986 return. The Service subsequently disallowed the \$32 million in losses from the farming operations, contending they resulted from sham transactions devoid of economic substance. The taxpayers settled their dispute with the Service by agreeing that the \$32 million loss was limited to \$17 million. In 1999, the taxpayers abandoned their partnership interest. In this refund claim, they argue that they are entitled to deduct their \$33,000 basis in their partnership interest. The Service opposed the claim on the grounds that the taxpayers' outside basis at time of abandonment was zero. The Court of Federal Claims explains the basics of the dispute through a simple hypothetical: "Assume that partner A becomes a partner in the AB partnership on January 1 and has an initial basis in the partnership of \$ 1,000 (calculated under sections 722 and 752 of the Code). For that year, year one, the partnership has a loss of \$100,000, of which A's distributive share is \$3,000. Then, in the succeeding year, year two, the partnership has income of \$33,333, of which A's distributive share is \$1,000. At the end of that second year, A abandons his interest in the partnership. What is his adjusted basis in his partnership at the time of this abandonment? Plaintiffs essentially claim that the adjusted basis at the time of the abandonment should be \$1,000—that although A's share of the distributive losses exceeded his original basis by \$2,000, his adjusted basis could never be reduced below zero; it then became \$1,000 when the partnership distributed the \$1,000 of income in year two (\$0 (adjusted basis in first year) + \$1,000 (adjustment for second year) = \$1,000). This leads, according to plaintiffs, to an abandonment deduction of \$1,000. For its part, defendant asserts that the partner's adjusted basis in his

partnership interest at the time of the abandonment is zero. It starts with the partner's basis of \$1,000, adds thereto the sum of subsequent distributions of income (\$1,000), and then subtracts therefrom the sum of subsequent distributions of loss (\$3,000). Defendant notes that while these calculations leave the taxpayer with a negative adjusted basis (-\$1,000), section 705(a)(2) sets that basis to zero, with the latter number then corresponding to the amount of the abandonment deduction. (\$1,000 (original basis) + \$1,000 (sum of distributed income) - \$3,000 (sum of distributed losses) = -\$1,000 or zero)." The court held that the Service's interpretation is more consistent with the structure and intent of § 705. "As a textual matter, [the words of § 705(a)] clearly anticipate that the calculation will be cumulative and reflect a partner's entire period of ownership—why else would the statute require that income and losses from not just the current taxable year or any set of years, but all *prior* years be summed in making the calculation. As such, it would appear that if a partnership incurs and distributes a significant loss in one taxable year, that loss is carried along in ultimately calculating what the adjusted basis of a partnership interest would be in a later year. This is important because, of course, the statute dictates that the adjusted basis at any particular point cannot go 'below zero.' The latter phrase, however, does not alter the way that the rest of the statute operates—it does not mean that the sum of the distributive shares of income and losses over the history of the partnership is permanently set to zero at any point that the sum becomes negative. For if that were true, the calculation of the adjusted basis in subsequent years would not reflect the sum of the distributive shares 'for the taxable year and *prior* taxable years'—such prior losses would be largely, and, in some cases, entirely, factored out of the equation, a result that cannot be squared with the statutory formula." The court accordingly held that the taxpayers had a zero basis at the time of abandonment and therefore no deduction from the abandonment. *LeBlanc v. United States* (Fed. Cl., December 4, 2009).

Section 707: Transactions Between Partner and Partnership

There Was a Disguised Sale, But the Service Took Too Long to Find It. Two domestic corporations formed a partnership with a foreign corporation in 1990. The corporations transferred \$480 million in assets to the partnership in exchange for all of the limited partner interests. The corporations, acting through trusts, then pledged the partnership interest as collateral for a \$460 million nonrecourse loan from a bank. The trusts then distributed \$450 million of the loan proceeds to the corporations. The partnership agreement provided that the limited partners (the corporations) were to receive monthly distributions to cover the corporations' repayment obligations under the loan. This "priority return" distribution was to be paid regardless of the partnership's income. The corporations took the position that all of this was a nontaxable formation of a partnership followed by tax-free distributions, but the Service argued it was a disguised sale of the assets transferred to the partnership. The district court agreed with the Service, noting several facts that suggested a disguised sale instead of a contribution-distribution transaction, including: the careful attention given to the form of the transactions; the "integrated and locking form" of the transactions; the fact that the transactions closed on the same date; the corporation's willingness to cede operational control over its assets; and that the structure caused the loan to function, in substance, as a payment. But the court also held that the Service's claim was time-barred because it failed to assess the tax due within the three-year statute of limitations period. The six-year limitations period did not apply because the Service could not prove by a preponderance of the evidence that the taxpayer omitted from its 1990 return an amount more than 25% of the stated gross income. *United States v. G-I Holdings, Inc.* (D.N.J., December 14, 2009).

No Disguised Sale Here, However. The taxpayers were partnerships formed to acquire interests in a diverse selection of other pass-through entities that were involved in the qualified rehabilitation of real property and thus entitled to federal and state tax credits. Each of the taxpayers had a number of investors (between them, they had 282 investors in all). The taxpayers decided to form an LLC to pool their capital to support large and small historic rehabilitation projects. The resulting state tax credits

could then be allocated to the partnerships and, ultimately, to the investors, as they may agree. The Service felt the investors were not partners for federal tax purposes. It believed the investors' capital contributions to the partnerships and their receipt of the state tax credits in return were really sales of state tax credits. In the alternative, if the investors were partners, the Service determined that the transactions were disguised sales of state tax credits and that each partnership recognized unreported income from these sales in the amount of its investors' collective capital contributions. The Tax Court respected the form of the taxpayers' transaction. Considering the conduct of the parties in the formation and execution of the LLC agreement, the parties' statements, the testimony of disinterested persons, the relationship of the parties, their respective capital contributions, and the actual control of income, among other things, the court was convinced that the investors legitimately pooled their resources together and created a partnership for tax purposes. Furthermore, there was no disguised sale of tax credits between the investors. The regulations state there is no disguised sale when the transactions are not simultaneous and the subsequent transfer is subject to the entrepreneurial risks of the partnership's operations. That was the case here, said the court. The investors contributed capital at various times during the years at issue, and the state tax credits were not allocated to the partners until the partnerships attached the certificates to their respective Schedules K-1. The time gap meant the investors were subject to risks. Yes, the investors were promised certain amounts of credits in their subscription agreements, but there was no guarantee that the partnerships would be able to pool a sufficient amount of credits to meet these demands. Since there was no disguised sale, the taxpayers' treatment of the transactions was respected. *Virginia Historic Tax Credit Fund 2001 L.P. v. Commissioner*, T.C. Memo 2009-295 (December 21, 2009).

Break Out the Tissues: Asset Transfer to LLC Was a Disguised Sale. The taxpayer is a paper company that manufactures and sells tissue and specialty packaging. Its wholly-owned subsidiary, Wisconsin Tissue Mills (WTM), planned to transfer its assets and most of its liabilities to a newly formed LLC in which WTM and an unrelated corporation would be owners. The taxpayer hired an investment bank and an accounting firm to advise it on structuring the transaction with the unrelated party. The taxpayer also asked the accounting firm for an opinion on the tax consequences of the transaction. The taxpayer conditioned the closing of the deal upon receipt of a "should" opinion from the accounting firm that the transaction would be free of immediate tax consequences. The accounting firm opined that the transaction should not be treated as a taxable sale but instead as a tax-free contribution of property to a partnership, so the transaction closed in 1999. In the deal, WTM's contributions comprised about two-thirds of the LLC's total assets. But WTM received a five-percent interest in the LLC and a special distribution of cash. WTM used a portion of the "special" cash to make a loan to the taxpayer. So after the deal, WTM's only assets were its LLC interest, a promissory note from the taxpayer, and a corporate jet. (The LLC obtained the funds for the cash distribution through a bank loan. The unrelated co-partner of WTM guaranteed the LLC's obligation to repay the bank loan, and WTM agreed to indemnify the unrelated co-partner if it were called on to make good on its guaranty.) In 2001, WTM sold its entire interest in the LLC to the unrelated party, and the taxpayer reported the gain from this sale on its 2001 return. But the Service contended that the 1999 formation of the LLC was a taxable sale of assets to the unrelated party, meaning the gain should have been taxed in that year. That led the Service to also assess a substantial understatement penalty for 1999. The Tax Court agreed with the Service that WTM's asset transfer to the LLC was a disguised sale under § 707(a)(2)(B), and that the gain from this sale belongs on the taxpayer's consolidated return for 1999. Because WTM's contribution of \$775 million in assets occurred simultaneously with the \$755.2 million cash distribution (certainly well within the two-year time frame triggering the presumption), the court applied the presumption that the transactions should be viewed as a sale. The taxpayer argued that it qualified under the regulation's "debt-financed transfer of consideration exception" to the disguised sale rule's two-year presumption. As the court explains, "The regulations except certain debt-financed distributions in determining whether a partner received 'money or other consideration' for disguised sale purposes. A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution exceeds the distributee partner's allocable share of the partnership liability." The court agreed with the

Service that WTM's share of the liability was far less than the amount of the distribution it received, so the distribution could not be dismissed as just the disbursement of borrowed funds from an unrelated transaction. The court also upheld the imposition of the accuracy-related penalty because the taxpayer lacked reasonable cause for not treating the transaction as a disguised sale. The taxpayer tried to reply on the accounting firm's opinion letter, but the court said it was unreasonable to do because the accounting firm "wore too many hats" in the transaction, and thus had a conflict of interest. The accounting firm actively planned and negotiated the transaction, drafted the transaction documents and audited the assets of both WTM and the LLC. It was problematic that the accounting firm fetched an \$800,000 flat fee instead of an hourly fee for its tax opinion, especially since it was "riddled with questionable conclusions and unreasonable assumptions." *Canal Corp. and Subsidiaries v. Commissioner*, 135 T.C. No. 9 (August 5, 2010).

Section 736: Payments to a Retiring Partner or a Deceased Partner's Successor in Interest

Law Firm Partner Received Guaranteed Payments, But He Knew How to Compute Outside Basis. The taxpayer was a tax lawyer at a large law firm in Florida. As an equity partner in the firm, he received 50 "Schedule C Units" each year. Each unit was worth \$300, so that meant he got \$15,000 worth of Units each year. He received these Units regardless of the firm's profitability, and the \$300 per Unit figure was never adjusted. If he left the firm voluntarily, he would forfeit the Units. But if he made it to age 68, he could retire and receive both the full value of his capital account and the full value of his Units. When he retired in 2003, the taxpayer was entitled to \$338,162, of which \$240,000 was for his Units. He received this amount over 12 equal payments paid from 2003 through 2006. The taxpayer initially treated all of the payments as cash distributions that were tax-free because they did not exceed his basis in his partnership interest. Then the taxpayer conceded that the payments for the Units were taxable but argued that they should be treated as long-term capital gain. The Service argued that the payments for the Units were guaranteed payments and thus ordinary income. It also asserted that the payments for the capital account were taxable because the taxpayer's basis in his partnership interest was less than originally determined. The Tax Court agreed with the Service that the payments for the Units were ordinary income, but held that the taxpayer did not have income from the payments for his capital account because the Service did not meet its burden of proving that payments in liquidation of the partnership interest exceeded the taxpayer's outside basis. On the character of the income from the payments for the Units, the court observed that each equity partner received the same number of Units each year for services rendered to the firm regardless of the partner's percentage interest in the partnership and without regard to the firm's income. The Units were not reflected in the partners' respective capital accounts, so they could not be considered part of a partner's partnership interest. The payments for the Units were thus guaranteed payments, meaning they were ordinary income. As for the taxpayer's basis in his partnership interest, the court was persuaded that the taxpayer "established a reasonable basis for us to determine that his 2005 capital account payments did not exceed his basis in his partnership property. Respondent did not address petitioner's evidence on brief and has not given us any reason to believe his calculation is more reliable than that of petitioner." But the court upheld the imposition of an accuracy-related penalty as regards the failure to report the payments for the Units. The taxpayer argued his failure to include the payments in income was reasonable because the firm incorrectly reported these payments as nonemployee compensation on Form 1099-MISC instead of reporting it as a distribution on Schedule K-1. He claimed it was reasonable for him to omit the \$80,000 from his 2005 return since he "could not possibly report the receipt of the payments both correctly and also in a manner that was consistent with the reporting" by the firm. In rejecting this argument, the court noted that the statute and regulations contain a mechanism through which a partner can report an item of income inconsistently with the way in which the partnership reports the item on its own return, provided the partner provides a statement reporting that inconsistent treatment to IRS. "As a tax attorney of long standing," said the court, the taxpayer "should be familiar with this mechanism. To simply not report the income is not reasonable and

does not show good faith.” In an unpublished opinion, the Eleventh Circuit affirmed, citing several facts in support of the conclusion that the taxpayer received a guaranteed payment that operated essentially as a retirement benefit: eligibility for payment on Units was at least partially tied to a partner’s reaching age 68; the payment obligations in connection with Units could be funded through a qualified retirement benefit plan; and the same monthly payment limits were placed on both retirement and Unit payments. *Wallis v. Commissioner* (11th Cir., August 11, 2010).

Section 752: Treatment of Certain Liabilities

Deerhurst Strategy Caught in Headlights. The taxpayer had more than \$60 million of income in 2000, mostly due to his sale of several stock options. That same year, the taxpayer invested in a foreign currency options investment strategy called “Deerhurst.” The strategy involved a series of transactions using an S corporation and a partnership. The transactions made use of the then-existing law that disregarded short options as liabilities for purposes of establishing one’s outside Basis in a partnership. As a result of the Deerhurst transactions, a partnership loss of about \$60.5 million passed through to the taxpayer’s wholly owned S corporation, which in turn passed through to him. The taxpayer’s 2000 return thus showed an adjusted gross income of just over \$26,000. In June, 2003, Treasury issued a regulation that expanded the definition of “liability” for purposes of § 752 to include “any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code.” As a result, a partner’s outside basis is generally reduced by the value of any contingent liability. If applied to the taxpayer’s Deerhurst transaction, it would have the effect of disallowing much of the pass-through loss for lack of sufficient outside basis. Sure enough, the effective date of the regulation was made retroactive to October, 1999. In November, 2003, the taxpayer filed an amended return for 2000. The amended return omitted the \$60.5 million loss, causing the taxpayer to pay about \$26 million in taxes, interest and penalties. In June, 2004, the Service issued a deficiency notice with respect to the amended return, concluding another \$22,204 in tax was due. It concluded the Deerhurst strategy was a “Son of BOSS” tax shelter. So in September, 2004, the taxpayer filed another amended return, this one reclaiming the \$60.5 million loss and requesting a refund of almost \$24 million. When the Service denied the refund claim, the taxpayer sued for refund in federal district court. The court held that the Deerhurst transaction had a bona fide business purpose and profit motive. The court felt that the taxpayers intended to generate a profit through the investment. It also concluded that each step in the transaction had legitimate purposes beyond tax avoidance. The court then held that the S corporation’s outside basis in the partnership was not reduced by the contingent liabilities reflected in the short options. This was because long-accepted case law in effect at the time of the transaction held that contingent liabilities like those involved with the short options are properly ignored when determining a partner’s outside basis. Of course, the Service argued that the new regulation, retroactive to the taxable year at issue, provided differently. But the court held that this interpretive regulation cannot apply retroactively because it is contrary to the statute it seeks to interpret. Specifically, the regulation was intended to prevent “the same types of abuses” that § 358(h) is designed to thwart, but the court concluded that § 358(h) applies only on much narrower grounds than the wide swath cut by the regulation. Because Treasury exceeded the scope of its interpretive authority, the regulation cannot be given retroactive effect. On appeal, the Tenth Circuit reversed. It had no problem finding that the transaction lacked economic substance. “Most compelling is that the claimed loss generated by the program was structured from the outset to be a complete fiction. It is clear the transaction was designed primarily to create a reportable tax loss that would almost entirely offset [the taxpayer’s] 2000 income with little actual economic risk. By acquiring a series of long and short options that largely offset one another, contributing them to Deerhurst GP in exchange for a partnership interest, and then almost immediately liquidating the partnership, [the taxpayer] was able to ensure that a tax loss nearly equivalent to [his] income would be achieved in just a few weeks. . . . Through this mechanism, the generated loss was designed to be entirely artificial. Indeed, rather than suffering any actual financial loss through

Deerhurst GP, [the taxpayer] actually profited from the transaction.” Because the transaction lacked economic substance, the claimed loss was disallowed. *Sala v. United States* (10th Cir., July 23, 2010).

Section 861: Income from Sources Within the United States

2010 Small Business Act: Income From Guarantees Provided to United States Persons Has United States Source. Effective as of September 27, 2010, amounts received from a United States person “for the provision of a guarantee of any indebtedness” of such person have United States source, as do any amounts received from any foreign person “for the provision of a guarantee of any indebtedness” of such person if the amounts received are connected with income that is effectively connected with a United States trade or business. An analogous change to § 862 provides that amounts received from a foreign person “for the provision of a guarantee of any indebtedness” of such person have foreign source if the amounts received are unrelated to “effectively connected income.” *Section 861(a)(9)*.

Section 877A: Tax Responsibilities of Expatriation

Treasury Explains Application of Deemed Asset Sales by Covered Expatriates. Under legislation enacted in 2008, most assets of a “covered expatriate” are deemed to be sold at fair market value on the day before expatriation. Generally, a “covered expatriate” is an expatriate (that is, a United States citizen that has relinquished citizenship or a long-term United States resident that ceases to be a lawful permanent resident) who: (1) has an average annual net income tax liability for the five prior years of more than \$124,000, as adjusted for inflation (the figure for 2009 and 2010 is \$145,000); (2) has a net worth of \$2 million or more; or (3) fails to certify under penalties of perjury compliance with all federal tax obligations for the five prior years. Under the general rule, all realized gains must be recognized, and those realized losses which would otherwise be recognized are deductible (except that § 1091’s limitation on losses from wash sales does not apply), although there is \$600,000 exclusion for net gains that would otherwise be includible in gross income from the deemed sale (this figure is adjusted for inflation—it was \$626,000 in 2009 and is \$627,000 in 2010). Treasury has now issued guidance on the application of this deemed sale regime. The new guidance provides that in computing tax liability, property is generally to be valued in accordance with the valuation principles applicable for federal estate tax purposes. The exclusion amount is to be allocated among the assets in relation to their relative built-in gains. The guidance also provides that an expatriate has only one lifetime exclusion, so one who expatriates more than once may only claim any unused portion from the expatriation on subsequent expatriations. If an expatriate again becomes a resident of the United States, then, absent an irrevocable election on Form 8854 to the contrary on a property-by-property basis, he or she has a basis in assets held on the date of expatriation of not less than the fair market value of the property on such date. If the covered expatriate was a United States citizen or resident for part of the taxable year before expatriation (i.e., a calendar year taxpayer expatriating on any date other than January 1), he or she must file a dual-status tax return (that is, a Form 1040NR with a Form 1040 attached as a schedule). The covered expatriate must also file an initial Form 8854 with his or her Form 1040NR or Form 1040, whichever is applicable, for the taxable year that includes the day before the expatriation date. Furthermore, the 2008 law provides that where a United States citizen or resident receives a gift or bequest from a covered expatriate, the recipient must pay a tax equal to the value of the covered gift or bequest times the highest marginal rate of federal estate tax (or, if greater, the highest marginal rate of federal gift tax). The tax is only applicable to the extent the cumulative value of all covered gifts and bequests received in a calendar year exceeds the annual exclusion amount under § 2503(b), and the amount of tax otherwise due under this new rule is reduced by the amount of any gift tax or estate tax paid to a foreign country with respect to such covered gift or bequest. Treasury has indicated that separate guidance will be forthcoming on the application of this tax to those who receive gifts or bequests on or after June 17, 2008. *Notice 2009-85* (October 15, 2009).

Section 881: Tax on Income of Foreign Corporations Not Connected with United States Business

Guarantee Fee Paid to Mexican Parent By United States Subsidiary Has Foreign Source. A Mexican corporation charged the taxpayer, one of its United States subsidiaries, a fee to guarantee the taxpayer's debts. The Service contended that the taxpayer should have withheld 30% of the fees paid to the Mexican parent as "fixed or determinable annual or periodical" income from United States sources. The Tax Court held that the guaranty fees are analogous to payments for a service. The fees were not like interest, according to the court, because the guaranty was not in substance a loan. The Mexican corporation was not required to pay out its own money unless the taxpayer defaulted. Since the source of income from services is where the services are performed, and because the guaranty was provided from Mexico, fees for the guaranty are Mexican source income. Accordingly, withholding was not required. For Congress's take on the matter, see the developments under § 861 above. *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010).

Section 882: Tax on Income of Foreign Corporations Connected with United States Business

Foreign Corporations Have New Rules to Compute Their Interest Expense Deductions. Foreign corporations are allowed to deduct that portion of interest expense allocable to income effectively connected with the conduct of a United States trade or business. The portion allocable to effectively connected income is determined under a three-part formula set forth in a regulation: first, the foreign corporation determines the total value of its United States assets; second, it computes the amount of United States-connected liabilities; third, the amount of interest paid or accrued on United States-booked liabilities is adjusted for interest expense attributable to the difference between United States-connected liabilities and United States-booked liabilities. Treasury has finalized slight modifications to this approach. Now, a taxpayer uses fair market value rather than adjusted basis in valuing United States assets in the first step and in computing United States liabilities for the second step. Foreign banks can elect to use a 95% fixed ratio in the second step in lieu of computing the actual ratio. Furthermore, a foreign bank with an excess of United States-connected liabilities over United States-booked liabilities can now elect to use the 30-day London Interbank Offering Rate (LIBOR) to calculate interest on the excess United States-connected liabilities. The new regulation is effective as of September 28, 2009. *Regulation § 1.882-5* (September 25, 2009).

Section 901: Taxes of Foreign Countries and of Possessions of United States

Failure to Exhaust Remedies Dooms Credit. The taxpayer's Japanese subsidiary manages its Japanese and Korean business operations. The taxpayer has no physical location in Korea, but instead contracts with a manufacturer and distributor located in Korea. During the taxable years at issue (2001-2005), the Japanese subsidiary paid royalties to the taxpayer, and the subsidiary withheld and paid a 10% Japanese royalty tax payment. The taxpayer claimed a foreign tax credit in the United States for the Japanese tax payment, which the Service ultimately allowed. The taxpayer did not pay tax to Korea on the royalty payments because it had no physical presence there. But that did not stop Korea from determining that the taxpayer owed a 15% royalty tax on the portion of the royalty payments attributable to sales in Korea. When the taxpayer learned from Korean counsel that it would be futile to challenge Korea's assertion of tax, it paid the tax and applied for an additional foreign tax credit in the United States for the Korean taxes paid. The Service denied the credit, claiming the taxpayer failed to exhaust all available remedies in Korea to reduce the tax. So the taxpayer brought the present action, and both sides filed motions for summary judgment. The court held that while the taxpayer is allowed a foreign tax

credit for the Korean tax paid to the extent it exceeded the Japanese taxes on the same income, it is not allowed a credit for both taxes because the taxpayer failed to seek relief from the *Japanese* taxes through Japanese law or competent authority procedures. “[W]hen in 2006 the Korean National Tax Service performed an audit ... and concluded that the royalty income was "Korean-sourced," [the taxpayer] should have sought a redetermination of the source of the royalty income under Japanese law or competent authority proceedings with regards to [the taxpayer’s] liability in Japan.” The court acknowledged that the taxpayer properly obtained the advice of counsel in Korea to assess the likelihood of reducing taxes paid there, but the taxpayer made no request for relief in Japan after Korea claimed tax due on income that Japan had already taxed. *Procter & Gamble Co. v. United States* (S.D. Ohio, July 6, 2010).

Section 1001: Determination of Amount of and Recognition of Gain or Loss

Decline in Creditworthiness of Issuer Won’t Be Considered Under Proposed Regulations. The so-called *Cottage Savings* regulations provide rules for determining when the modification of a debt instrument results in a deemed exchange of the old instrument for a new instrument. The regulations currently provide that any deterioration in the financial condition of the issuer between the issue date of the unmodified debt instrument and the date of modification (as it relates to the issuer’s obligation to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor. But this rule only applies for purposes of determining whether an alteration changes an instrument from a debt instrument to a property right. As Treasury explains, “Issuers and holders, however, are concerned that, as the existing regulations are currently drafted, a decline in the creditworthiness of the issuer, under certain circumstances, *may* be taken into account under [the *Cottage Savings* regulations]. The uncertainty about the proper interpretation of the existing regulations has led taxpayers to request clarification on the circumstances in which the credit quality of the issuer should be considered in determining the nature of the instrument resulting from an alteration or modification of a debt instrument.” Accordingly, Treasury has proposed regulations stating that any deterioration in the financial condition of the issuer is generally not taken into account to determine if the modified instrument is debt. “For example, under the proposed regulations, any decrease in the fair market value of a debt instrument (whether or not publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the issuer and not to a modification of the terms of the instrument. Consistent with this rule in the proposed regulations, if a debt instrument is significantly modified and the issue price of the modified debt instrument is determined under § 1.1273-2(b) or (c) (relating to a fair market value issue price for publicly traded debt), then any increased yield on the modified debt instrument attributable to this issue price generally is not taken into account to determine whether the modified debt instrument is debt or some other property right for federal income tax purposes. However, any portion of the increased yield that is not attributable to a deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account.” The proposed regulations would become effective when finalized. *Proposed Regulation § 1.1001-3(f)(7)* (June 21, 2010).

Stock Loan Program Treated As Sale. Acting on the advice of his financial advisor, the taxpayer, an IBM employee, entered into a “90% stock loan program” with an LLC called Derivium Capital. The taxpayer transferred 990 of his IBM shares (worth \$105,445 and with a basis of \$21,171) to Derivium in exchange for \$93,586. The agreement between the taxpayer and Derivium characterized the transaction as a three-year loan of 90% of the value of the IBM stock, with the stock pledged as collateral. The agreement allowed Derivium to sell the stock (which it did immediately upon receipt). The loan’s terms were nonrecourse as to the taxpayer (recourse against collateral only), with dividends to be received by Derivium as cash payments against the interest due (the interest rate was 10% compounded annually).

The balance of the interest was to accrue until the loan's maturity date, and the loan was non-callable before maturity. The arrangement provided for no prepayment before maturity. At maturity, the taxpayer had the option of either paying the balance due and having an equivalent amount of IBM stock returned to him, renewing the purported loan for an additional term, or simply surrendering any right to receive IBM stock. When the repayment obligation matured in 2004, the balance due on the loan was almost \$41,000 more than the value of the IBM stock at that time, so the taxpayer elected to surrender any right to get the IBM stock back. The taxpayer did not report the amount he received from Derivium on his 2001 return, and he did not report the termination of the transaction on his 2004 return. The Service took the position that this was in effect a sale of the IBM stock and not a loan. The Tax Court agreed that this transaction was in fact a sale of the stock in 2001. A number of factors pointed to a disguised sale. Derivium was authorized to sell the stock immediately upon receipt without having to give notice to the taxpayer. The taxpayer never reported dividends paid on the stock while the "loan" was outstanding. Once the taxpayer got his \$93,000 and change from Derivium, he bore no risk of loss if the value of the IBM stock decreased. The court observed its decision was consistent with those of two other federal courts in recent cases. *Calloway v. Commissioner*, 135 T.C. No. 3 (July 8, 2010).

Section 1031: Like-Kind Exchanges

Transactions Dressed to Qualify for Nonrecognition Get Stripped. The taxpayer engaged in two like-kind exchanges through the use of a qualified intermediary. In one of the transactions, the taxpayer owned the Ocean Vista condos, a parcel of Hawaiian real property coveted by an unrelated party who had cash to buy it. The taxpayer agreed to sell Ocean Vista if a like-kind exchange could be structured. Meanwhile, the taxpayer contacted a related party (another corporation in which the taxpayer held a 62.5% interest) regarding the acquisition of K2, another parcel of real property. The related party agreed to participate in a like-kind exchange for the sale of K2 to the taxpayer. Accordingly, the taxpayer, the unrelated buyer, and the related seller entered into a deferred exchange using a qualified intermediary. When the dust settled, the taxpayer had K2, the unrelated buyer had Ocean Vista, and the related party had cash. The taxpayer deferred \$1.3 million in gain from the transaction. The second transaction at issue in this case involved different properties but was substantially the same as the first exchange. The taxpayer deferred \$10.7 million of gain from the second transaction. The Service issued a deficiency after concluding that the taxpayer did not qualify for nonrecognition under § 1031. Specifically, the Service determined that the transactions fell within § 1031(f). Section 1031(f)(1) requires a taxpayer to recognize deferred gain or loss from a like-kind exchange with a related party where the related party disposes of the property surrendered by the taxpayer within two years of the exchange. The Service concluded that the effect of the transactions as structured was identical to a like-kind exchange of Ocean Vista for K2, followed by the related party's sale of Ocean Vista to the unrelated buyer for cash. While not within the technical reach of § 1031(f)(1), the Service argued that the transactions were structured to avoid § 1031(f)(1), and § 1031(f)(4) provides that nonrecognition does not apply "to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of" § 1031(f). In Tax Court, the taxpayer argued that because the transactions did not have a "principal purpose" of tax avoidance, the exception in § 1031(f)(2)(C) for pure-heart transactions applied. As proof of its innocent intent, the taxpayer argued that the related party recognized gain by receiving cash from the transactions instead of like-kind property. The taxpayer claimed that if it was intending to circumvent § 1031(f)(1), it would structure the deal so that neither the taxpayer nor the related party would recognize gain. But the court noted that the gain recognized by the related party, thanks to NOL carryovers, was substantially smaller than the gain that would have been recognized by the taxpayer had the related parties effected a direct like-kind swap followed by the related party's sale for cash. The lower court thus upheld the Service's application of § 1031(f)(4) to the taxpayer. On appeal, the Ninth Circuit affirmed. As the court observed, "it appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f). [The taxpayer] could have exchanged its properties directly with

[the related party], followed by [the related party] selling Ocean Vista ... to the third-party purchasers. There was no need to use (and pay) a qualified intermediary. The rub, of course, is that [the taxpayer] couldn't have done this tax free, as direct exchanges between related parties are ineligible for nonrecognition treatment when the exchanged property is sold within two years. Instead, [the taxpayer] employed [the qualified intermediary], whose presence ensured that [the taxpayer] was technically exchanging properties with the qualified intermediary, not with its related party. [The qualified intermediary's] involvement in these transactions thus served no purpose besides rendering simple—but tax disadvantageous—transactions more complex in order to avoid § 1031(f)'s restrictions.” *Teruya Bros. Ltd. v. Commissioner* (9th Cir., September 8, 2009).

Qualified Intermediary's Bankruptcy Won't Preclude Nonrecognition. What's a poor taxpayer to do when a qualified intermediary goes bankrupt and thus defaults on its obligation to acquire and transfer replacement property? According to new guidance, the taxpayer need not worry. If the taxpayer meets the requirements of a new safe harbor, the taxpayer will not have to recognize gain from the failed exchange until the taxpayer receives a payment attributable to the relinquished property. To used the safe harbor, the taxpayer must have transferred the relinquished property to a qualified intermediary, properly identified the replacement property within the identification period, did not complete the like-kind exchange solely because of the qualified intermediary becomes subject to a bankruptcy proceeding under federal law or a receivership proceeding under federal or state law, and not be in actual or constructive receipt of the proceeds from the disposition of the relinquished property prior to the time the qualified intermediary filed for bankruptcy or entered receivership. If a taxpayer meets these requirements, the taxpayer may report gain on the disposition of the relinquished property as the taxpayer receives payments attributable to the relinquished property using the “safe harbor gross profit ratio method.” Under this method, the portion of any payment attributable to the relinquished property treated as recognized gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price. This guidance is effective for taxpayers whose like-kind exchanges fail due to a qualified intermediary's default occurring on or after January 1, 2009. *Revenue Procedure 2010-14* (March 5, 2010).

Nitrogen Oxide Credits and Volatile Organic Compound Credits are Like-Kind. The taxpayer creates nitrogen oxide (NOx) and volatile organic compounds (VOCs) during the course of its business operations. Under a program to control air pollution, businesses that take steps to reduce pollution emissions receive emission reduction credits that can be used to offset emissions that would otherwise exceed permitted levels. The taxpayer has more NOx Credits than it needs, but it is in desperate need of additional VOCs Credits. So it plans to exchange its excess NOx Credits for VOCs Credits held by unrelated third parties. The Service ruled that VOCs Credits and NOx Credits are like-kind property for purposes for purposes of § 1031. Sure, NOx and VOCs are different chemical compounds, but they are both ozone-causing pollutants, and controlling ozone damage was the primary purpose of the Credits in the first place. Consequently, the differences between NOx and VOCs, as they relate to the Credits and the purposes for issuing the Credits, are mere differences in grade or quality, not nature or character. *Private Letter Ruling 201024036* (June 18, 2010).

Beware Transactions with Related Parties, Even When Qualified Intermediary is Involved. The taxpayer, a real estate development corporation, transferred a parcel of appreciated property (let's call it Blackacre) to a qualified intermediary (a bank). At the time of the transfer, Blackacre was worth about \$7 million and the taxpayer's basis in the property was about \$715,000. Sometime after the transfer, the qualified intermediary sold Blackacre to an unrelated third party for about \$7.25 million. Now the qualified intermediary had to find replacement property. The taxpayer hoped to identify new property from an unrelated party, but it could not find anything suitable. Ultimately, the qualified intermediary purchased a parcel of land (we'll call it Whiteacre) from a limited liability company that is related to the taxpayer (they share a number of common owners). Whiteacre was worth about \$6.75 million at that

time, and the LLC's basis in the property was about \$2.55 million (the LLC had acquired Whiteacre from the taxpayer years ago). The qualified intermediary then transferred Whiteacre to the taxpayer. One senses that the taxpayer was less than thrilled to reacquire some old property from a related party, but at least it completed the transaction within applicable time limits. On its 2004 return, the taxpayer reported a realized gain of about \$6 million but claimed that none of the gain was recognized because the series of steps combined to create a like-kind exchange. The Service raised a stink, observing that this deal was functionally the same as if the taxpayer had conveyed Blackacre to the LLC for Whiteacre, only to watch the LLC sell Blackacre to unrelated buyer for cash. If the transaction had taken that form, the Service argued, the taxpayer would be required to recognize the gain under § 1031(f)(1). Well, said the taxpayer, the transaction at issue did not take that form—instead it utilized a qualified intermediary, and since all of the steps were followed to effect a valid like-kind exchange through an intermediary, the taxpayer argued that its reporting of the transaction should be respected. The parties took their arguments to the Tax Court. The court agreed with the Service. Although the transaction did not take the form proscribed by § 1031(f)(1), § 1031(f)(4) also disqualifies transactions “structured to avoid” § 1031(f)(1), i.e., a transaction with a tax avoidance purpose. To determine whether this transaction had a tax avoidance purpose, the court compared the results of a sale of Blackacre by the taxpayer with the results of a like-kind exchange between the taxpayer and the LLC followed by the LLC's sale of Blackacre. Had the taxpayer exchanged Blackacre for Whiteacre directly, the LLC's \$2.55 million basis in Whiteacre would have carried over the Blackacre, and this is about \$1.8 million more basis than the taxpayer had in Blackacre. Further, since Blackacre would be a capital asset in the hands of the LLC and its members, any tax on the resulting gain would have been paid at a rate of 15% instead of the 34% applicable to the taxpayer. So by roping in the related party, the taxpayer was effectively able to add to basis and reduce the rate of taxation. “We are not prepared to say that, as a matter of law, a finding of basis shifting precludes the absence of a principal purpose of tax avoidance, but, in this case, the immediate tax consequences resulting from petitioner's deemed exchange with [the LLC] included an approximately \$1.8 million reduction in taxable gain and the substitution of a 15-percent tax rate for a 34-percent tax rate. The tax savings are plain, and petitioner's counterfactors are unconvincing or speculative. Petitioner has failed to convince us that tax avoidance was not a principal purpose of the deemed exchange.” Accordingly, the Service's deficiency was upheld. On appeal, the Eleventh Circuit affirmed after finding no clear error. This arrangement was the economic equivalent of a direct related-party exchange to which §1031(f)(1) would clearly apply, the court held. The transaction had unneeded complexity, and that suggested a tax-avoidance purpose. *Ocmulgee Fields, Inc. v. Commissioner* (11th Cir., August 13, 2010).

Section 1033: Involuntary Conversions

Taxpayer Not in Constructive Receipt of Condemnation Award, So Replacement Period Begins When Challenge of Condemnation Resolved. A city agency filed a condemnation action to acquire the taxpayer's property in Year 1. As required under applicable law, the agency deposited an amount as “probable compensation” for the property with the state treasurer. The taxpayer could have applied for withdrawal of this deposit at any time, but doing so would have forfeited the taxpayer's ability to challenge the agency's action. In fact, the taxpayer very much wanted to challenge the action, so it did not exercise this withdrawal power. At some point in Year 2, the taxpayer and the agency settled their dispute and the taxpayer received the deposited funds. The taxpayer wanted a ruling that it was not in constructive receipt of the deposit in Year 1 and that the three-year clock for acquiring replacement real property under § 1033(g) did not start until the taxpayer's challenge to the agency's action settled. The Service gave both of the requested rulings. There was no constructive receipt, since the condition that the taxpayer had to drop all claims against the agency was a “substantial limitation or restriction” on the taxpayer's use of the deposited funds. As a result, the taxpayer did not realize any gain until Year 2, meaning the three-year replacement period could not begin for that time. *Private Letter Ruling 200944012* (October 30, 2009).

Proceeds From Escheated Stock Can Qualify for Nonrecognition. The taxpayer in this ruling is a family limited partnership. It originally held stock in “Corporation A.” When “Corporation B” acquired Corporation A, the shareholders of Corporation A (including the taxpayer) received Corporation B stock, but the deal was structured so that roughly 75% of the Corporation B stock was distributed directly to the shareholders and two escrow accounts were set up to hold the remaining 25% of Corporation B stock for each shareholder. The first escrow was distributed about one year later. For whatever reason, the taxpayer never received the distribution from the second escrow. Before the second escrow was scheduled to release, the taxpayer’s original trustee (the managing partner perhaps?) died. When a new trustee was appointed, he was unaware of the stock in the escrow account. After unsuccessfully attempting to communicate with the dead former trustee, the escrow agent transferred the taxpayer’s shares remaining in the second escrow account to the state in accordance with applicable unclaimed property law. The state sold the shares and kept the cash proceeds, publishing its holding of the funds as unclaimed property. Sometime later, the taxpayer’s successor trustee learned of the state’s holding of the unclaimed property, and the trustee placed a claim for it with the state. The state subsequently transferred the proceeds to the taxpayer’s brokerage account. The Service ruled that the taxpayer can qualify for nonrecognition under § 1033 by replacing the cash proceeds with qualified replacement property within two years of the date when the proceeds of the state’s sale of the stock were made available to the taxpayer. The escheat was an involuntary conversion because the taxpayer did not intentionally fail to exercise ownership rights over the stock. The state was not simply an agent or fiduciary with respect to the funds; its law required the proceeds to be deposited into the state’s general fund and to be used for state purposes. Moreover, the state was not required to pay to the taxpayer interest on the proceeds from the sale of the seized stock, nor was the taxpayer entitled to any earnings the state may have derived from the proceeds. Clearly, once the state sold the stock, the proceeds were held for public use and there was a completed seizure of the taxpayer’s property. Accordingly, the taxpayer is eligible for the benefit of the nonrecognition under § 1033. *Private Letter Ruling 200946006* (November 13, 2009).

Section 1202: Partial Exclusion for Gain from Certain Small Business Stock

Options Aren’t Stock. The taxpayer worked for Cognet Microsystems, and during the course of his employment he acquired options to purchase Cognet stock. In 2001, Intel Corporation acquired Cognet, and pursuant to the merger agreement, the taxpayer’s options to buy Cognet stock became options to buy Intel stock. Late in 2003, the taxpayer exercised his options and purchased Intel stock. He sold the stock the same way for a gain of almost \$300,000. This gain was reported on the taxpayer’s Form W2 for 2003. The taxpayer maintains that he can exclude half of the gain under § 1202. The Tax Court observed that while the statute permits the “tacking on of a holding period upon conversion of small business stock into other stock, petitioner does not assert that he ever held Cognet stock that he subsequently converted into Intel stock. Instead, petitioner seems to be arguing that references to the term ‘stock’ in section 1202 should be read to include options to acquire stock. ... [W]e do not believe that the term ‘stock’ in section 1202 includes options to acquire stock. Even if it did, however, petitioner has failed to establish that Cognet constituted a qualified small business on the day or days that he received his options and that he held such options for more than 5 years.” *Oops. Natkunanathan v. Commissioner*, T.C. Memo. 2010–15 (February 1, 2010).

2010 Small Business Act: Throw in a Sham-Wow and a Slanket And Then Maybe We’ll Be Interested. Section 1202(a)(1) generally excludes half of the gain from the sale or exchange of “qualified small business stock” (generally, stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is

engaged in an active business and has aggregate gross assets of \$50 million or less) held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent under § 1(h)(1)(E). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all). Legislation in 2009 increased the exclusion to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011. Where the special 75 percent exclusion applies, then, the effective rate of tax on the entire gain is only seven percent (a quarter of the gain is taxed at 28 percent, the rest is untaxed). This gives § 1202 some much-needed bite. Where the 50 percent exclusion applies, a taxpayer saves only one percent (§ 1202 offers a rate of 14 percent, but current law would tax the entire gain at only 15 percent). But with a 75% exclusion, the savings can be meaningful. Congress has gone one step further in the name of small business stimulus: for qualified small business stock acquired from September 28, 2010, through December 31, 2010, 100% of the gain will be excluded, reducing the effective tax rate to zero. What's next—a credit on top of an exclusion? Of course, given that one must still hold the stock for five years in order to claim the benefit of § 1202, it won't be until 2015 before taxpayers begin to feel the benefit of this increased exclusion. § 1202(a)(4).

Section 1221: Capital Asset Defined

Payment in Trade Secret Misappropriation Settlement is Ordinary Income. The taxpayer is a shareholder in an S corporation that obtained a patent on the process for making precooked sausage that had the appearance and taste of home-cooked sausage. Pizza Hut approached the corporation, interested in using the process nationwide in its stores. After long negotiations, Pizza Hut and the corporation entered into a confidentiality agreement under which the corporation disclosed to Pizza Hut its process, including improvements it had made after obtaining the patent. Pizza Hut agreed not to disclose the information to anyone outside of Pizza Hut without the corporation's written consent and not to use the information for the benefit of anyone other than Pizza Hut without the corporation's consent. Guess what? Pizza Hut disclosed the corporation's trade secret to one its largest suppliers of meat products without getting the corporation's consent. Once the supplier started using the corporation's process, Pizza Hut started buying less sausage from the corporation. The corporation sued, alleging trade secret misappropriation. In 2000, a jury sided with the corporation. In 2002, pursuant to a settlement agreement, Pizza Hut paid over \$15 million to the corporation. On its 2002 return, the corporation treated the settlement as long-term capital gain. The Service determined that the payment should have been treated as ordinary income, so deficiencies followed against the shareholders. The taxpayer and the other shareholders marched to Tax Court, but the court agreed with the Service. It rejected the taxpayer's claim that the trade secret was a capital asset and that the settlement agreement represented damage to the capital asset. The corporation's lawsuit asked for damages for "lost profits, lost opportunities, operating losses and expenditures," proof that the damages received were substitutes for items taxed that would have been taxed as ordinary income. The taxpayer argued that Pizza Hut's payment was really proceeds from the sale of the secret, but the court observed that the taxpayer did not sell all substantial rights to the patent or even an undivided portion of the entire patent, so the attempt to cast the transaction as a sale was improper. The taxpayer tried to argue that the payment should be treated as capital gain under § 1234A, but the court noted that there was no evidence that Pizza Hut's settlement payment in any way terminated the corporation's rights to the trade secret. *Freda v. Commissioner*, TC Memo 2009-191 (August 25, 2009).

Surrender of Life Insurance Policy Yields Ordinary Income. In 1980, the taxpayer and his sister were co-owners and beneficiaries of a \$200,000 insurance policy on their mother's life. The taxpayer and his sister paid all of the premiums (at first using funds gifted from their mother, but eventually using their own funds) until the policy started paying its own premiums using dividend accumulations. By 2005, the taxpayer had become the sole owner of the policy. At that time, the

insurance company indicated that “the net investment in the policy at the time was \$225,390.14, the total cash value was \$361,353.58, the total indebtedness was \$354,399.25, and the taxable gain was \$135,963.44.” The taxpayer elected to surrender the policy and received a check of just over \$11,000 (representing the total cash value plus a terminal dividend of about \$4,000, less the outstanding policy loan balance). When the taxpayer included nothing in gross income from the surrender of the policy, the Service came knocking. In turn, the taxpayer knocked on the doors of the Tax Court. The court held that the taxpayer had gross income of \$135,963.44, observing that “[t]he satisfaction of the loans had the effect of a pro tanto payment of the policy proceeds to petitioner and constituted income to him at that time.” Further, the court held that the gain was ordinary income because there had been no sale or exchange of a capital asset. The taxpayer acknowledged the weight of authority in support of ordinary income treatment, but argued “maybe it’s time for a change in the law.” Remarkably, the court demurred on this point, claiming the argument “should be raised before Congress, not the Tax Court.” *Barr v. Commissioner*, T.C. Memo. 2009-250 (November 3, 2009).

Section 1272: Current Inclusion in Income of Original Issue Discount

Don’t You Kind Of Hate It When Banks Win? Banks look for all kinds of ways to make money through the issuance of credit cards. One source of revenue is the so-called “intercharge” on every swipe of the card. When a cardholder uses a credit card to purchase an item, the cardholder agrees to pay the issuer the full purchase price (don’t even get started with interest and late fees). But Visa and MasterCard withdraw something less than that amount from the issuer for delivery to the merchant. The amount that the issuer gets to keep is the intercharge. This case concerns the proper tax treatment for the issuer’s income from intercharge revenues. The taxpayer treated the intercharge as original issue discount under the theory that it acquired the credit card loans at a discount, the discount being the amount of intercharge. But the Service sees the intercharge not as a form of interest income but rather as a service fee paid by the merchant or the merchant’s bank, not by the “borrower” (the cardholder). The Tax Court held that the taxpayer properly treated the intercharge as OID. Just like interest, according to the court, intercharge compensates the taxpayer for its costs of lending money, like credit risks and fraud risks. And just like interest, the amount of intercharge increases as the amount of the loan increases. Accordingly, the taxpayer accrues the income from intercharge not when the taxpayer’s right to payment becomes fixed but instead over the anticipated life of the pool of credit card loans to which the intercharge relates. That brought the court to the other main issue: whether the taxpayer properly computed the amount of OID that accrued in each of the years at issue. The Tax Court held that the formula used by the taxpayer to calculate the OID was reasonable, making the taxpayer two-for-two. Alas, the taxpayer lost one minor issue in this case: the court held that the taxpayer could not immediately deduct the estimated cost of future redemptions of airline miles it issued to certain cardholders. Instead, the deduction must wait until “economic performance” occurs (i.e., when the miles are redeemed). *Capital One Financial Corp. v. Commissioner*, 133 T.C. No. 8 (September 21, 2009).

Section 1361: S Corporation Defined

Boom Goes the S Election: Custodial Roth IRA is Ineligible Shareholder. Throughout 2003, the taxpayer’s sole shareholder was a custodial Roth IRA account for the benefit of one Paul DiMundo. The taxpayer filed a Form 1120S for 2003, but the Service issued a deficiency on the grounds that the taxpayer was not an S corporation because it had an ineligible shareholder. It computed tax liability as though the taxpayer was a C corporation. A regulation finalized in 2008 makes it clear that Roth IRAs are ineligible shareholders, but this regulation was not in effect in 2003. So the Tax Court had to determine whether a custodial IRA could be an eligible shareholder in the absence of definitive guidance. Before the Tax Court, the taxpayer argued that the custodial Roth IRA was effectively a custodian or

agent for DiMundo and that, therefore, DiMundo should be viewed as the shareholder. The court (in a 12-4 decision) rejected this line of reasoning, distinguishing a custodial Roth IRA from traditional custodial arrangements where the beneficiary is incapacitated or a minor. The taxpayer also argued that the custodial IRA was a grantor trust and thus an eligible shareholder, but the majority rejected this argument too, citing a 1992 revenue ruling that “sensibly distinguishes IRAs from grantor trusts governed by sections 671-679. ‘When a grantor or another person is treated ... as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion.’ That, of course, is not the case with traditional and Roth IRAs--earnings accrue tax free in both entities. It follows that the tax relationship between an individual beneficiary and a traditional or Roth IRA is not governed by the grantor trust provisions.” Further, the majority found no compelling evidence that Congress ever intended for IRAs to be eligible S corporation shareholders. In dissent, Judge Holmes states that since the custodial relationship is clear in this case, the real shareholder is DiMundo and not the IRA. “In various custodial account agreements preapproved by the IRS, the depositor (owner) is responsible for providing information to the custodian; he can combine IRAs to satisfy the minimum distribution requirements under section 408(a)(6); he can replace the custodian at any time; he is himself responsible for any fees, taxes and administrative expenses; and he directs and controls the investments in the account. Such agreements—while obviously not controlling here—at least suggest in their apparent uniformity that custodial account IRAs would likely be found at trial to be under the control of their owners. It is hard to see how they could be considered ‘persons’ of their own, instead of channels through which their owners direct and manage their investments.” *Taproot Administrative Services, Inc. v. Commissioner*, 133 T.C. No. 9 (September 29, 2009).

Section 1366: Pass-Thru of Items to Shareholders

Guess What? Shareholder Guarantee of S Corporation Debt Still Doesn't Give the Shareholder Basis. The taxpayer is an attorney (strike one) who owns all of the stock in his S corporation. In 2000, the taxpayer personally guaranteed a line of credit extended to the corporation (strike two). In 2003, the corporation generated net losses, and the taxpayer wanted to deduct those losses that passed through to him. Just one problem: the taxpayer lacked stock basis. The taxpayer claimed the losses anyway (strike three), asserting that the personal guarantee gave him either stock basis (the guarantee is a contribution to capital) or debt basis (the guarantee puts him in the position as if the loan was made to him and he re-loaned to the corporation). Sadly, there is a veritable mountain of authority that clearly establishes that “[n]o form of indirect borrowing, including a guaranty, gives rise to indebtedness from the corporation to the shareholders for such purpose until and unless the shareholders pay part or all of the obligation. ... Until the guarantor pays the obligation, the guarantor does not have actual investment” (emphasis deleted from original). So the taxpayer could not deduct the losses in 2003. Now the next year, in 2004, the taxpayer took out a personal loan and used over \$150,000 of the proceeds to pay off the corporation’s debt. The Tax Court agreed that the taxpayer’s action gave him basis against which he could deduct the 2003 losses—in 2004, the year the taxpayer made the payment. But since 2003 was the only year at issue in the case, the court sided with the Service. *Weisberg v. Commissioner*, T.C. Memo. 2010-55 (March 22, 2010).

Section 1367: Adjustments to Basis of Stock of Shareholders, Etc.

Capital Contributions Add to Stock Basis, Not Debt Basis. Our taxpayers are two brothers who each made capital contributions in exchange for 25% shares in three separate S corporations, all formed to operate food distribution businesses. Heading into 2001, each brother’s stock basis in the companies was zero, and even the basis in loans made to the corporation had been reduced to nearly zero. In February of 2001, one of the S corporations repaid loans each brother made in the amount of \$649,775. Since debt

basis had already been reduced to zero, the brothers were staring at ordinary income from the repayment. Also in 2001, the brothers each made a capital contribution of \$537,228. The brothers couldn't claim this as debt basis, of course, so they treated it as tax-exempt income of the S corporation. If this characterization was correct, then the added basis from the "income" would be used first to restore debt basis, meaning that the earlier loan repayment would no longer constitute ordinary income. A clever approach, but it didn't work. The Tax Court agreed with the Service that a capital contribution is not exempt income to an S corporation, so there was no ability to add to debt basis. The capital contributions only served to increase each shareholder's stock basis. It didn't help that a regulation under § 118 specifically provides that capital contributions do not constitute income to an S corporation. On appeal, the brothers argued that if capital contributions were not income, § 118 would not have to specifically exclude it from gross income. But the Second Circuit affirmed, observing that capital contributions traditionally have not been treated as gross income in the first place. That § 118 explicitly excludes them does not transform them into "items of income" for purposes of S corporation stock basis adjustments. *Nathel v. Commissioner* (2d Cir., June 2, 2010).

Section 1374: Tax Imposed on Certain Built-In Gains

2010 Small Business Act: Recognition Period Temporarily Reduced to Five Years. When a C corporation makes an S election, the § 1374 tax looms. This corporate-level tax applies to any "net recognized built-in gains" during the "recognition period" (generally, the first ten years following the former C corporation's subchapter S election). Legislation in 2009 shortened the recognition period to seven years for 2009 and 2010 only. Now, for taxable years beginning in 2011 only, the recognition period has been shortened to five years. So if the corporation made its S election effective for 2006, any net recognized built-in gains in 2011 will not be subject to the tax. Curiously, however, any net recognized built-in gains in 2012, the seventh year of S corporation status, would be subject to the tax. *Section 1374 (d)(7)(B)*.

Section 1411: Imposition of Tax

2010 Health Care Act: New 3.8% Surtax on Investment Income Coming to a Theater Near You. Starting in 2013, wealthy individuals will pay a 3.8% surtax on "net investment income." The tax only applies to individual taxpayers with a "modified adjusted gross income" (generally meaning the taxpayer's adjusted gross income plus any foreign earned income excluded under § 911) in excess of the "threshold amount." The threshold amount for married taxpayers filing jointly is \$250,000 (\$125,000 for married filing separately), and the threshold amount for all other taxpayers is \$200,000. For purposes of this surtax, a taxpayer's net investment income includes interest, dividends, rents, royalties, capital gains, annuity income, and passive activity income. The statute expressly provides that net investment income does not include the income from an active trade or business, distributions from individual retirement accounts, distributions from qualified plans, gain from the sale of an active interest in a partnership or S corporation, and income taken into account in computing self-employment tax. To the extent the tax only applies to items of "income," it should not apply to excluded forms of income like municipal bond interest and, for instance, the gain from the sale of a principal residence. The 3.8% tax is applied against the taxpayer's net investment income or the amount by which modified adjusted gross income exceeds the threshold amount, whichever is less. In the case of an estate or trust, the tax is 3.8% of the undistributed net investment income or, if less, 3.8% of the amount by which adjusted gross income exceeds the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. The tax does not apply to a nonresident alien or to a charitable trust. *Section 1411*.

Section 2031: Definition of Gross Estate

Another Victory for the Built-in Gains Discount. At the decedent's death in 2005, her revocable trust held 164 shares of stock in Wa-Klo, a closely held C corporation that operated a summer camp for girls on a 94-acre waterfront parcel in New Hampshire. The corporation owned the land, and its improvements includes state-of-the-art playing fields, an indoor gym, a horse stable, a dining hall, cottages, and bunkhouses. The trust's holdings comprised 82% of the Wa-Klo stock. An appraisal determined that the net asset value of the company was about \$4.2 million. From that, the appraisal subtracted an estimated built-in long-term capital gain tax of \$965,000, meaning that the trust's 82% share of the \$3.3 million after-tax net asset value was about \$2.7 million. The appraisal applied this built-in gains tax discount even though neither a sale nor a liquidation of the company nor a sale of its assets was imminent or even contemplated. The estate's Form 706 claimed a modest marketability discount that reduced the value of the trust's Wa-Klo stock to about \$2.5 million. The Service determined a deficiency after reducing the built-in gains discount to about \$250,000. Before the Tax Court, the Service's expert concluded that the discount for built-in gains should be limited to about 45% of the company's estimated tax liability (here, about \$425,000) because that was consistent with discounts taken in valuing various closed-end mutual funds. The court agreed with the estate that reference to closed-end funds was inappropriate because closed-end funds tend to invest in various economic sectors, whereas the corporation here operated a single business activity (the camp) with a single principal asset (the land). After computing a range of potential values for the corporation's assets and estimating the present value of the potential capital gains tax liabilities, the court ultimately determined that the estate's claimed built-in gain discount was proper because it was within the range of acceptable values. *Estate of Jensen v. Commissioner*, T.C. Memo. 2010-182 (August 10, 2010).

Section 2033: Property in Which the Decedent Had an Interest

I'm Scared Even to Write About This One. The decedent led an interesting life. Known as "Bobby" to all who knew him, his "persona was such that he doggedly refused to back down to anyone. Such a strong-willed personality caused Bobby, as a youth, to 'seek and find trouble.'" He was twice indicated for robbery, grand larceny, and assault, and he served six years in Sing Sing Prison. About ten years after his release, Bobby became co-owner and president of a New Jersey warehouse and export business. The company closed in 1984 "because of severe financial problems, caused in part by its employees' misappropriating company funds as well as the company's having to borrow at a high rate of interest." Upon liquidation, Bobby owed just under \$500,000 in trust fund penalties for failing to pay over withheld employee taxes. "In addition Bobby owed a large amount (in the hundreds of thousands of dollars) to overseas creditors including some who allegedly belonged to the Chinese mafia." Some time later, two of Bobby's brothers started their own warehouse business. They turned to Bobby for help, and soon their business started making secret payments to Bobby for his services. "Each week an employee of [the new company] would write a check from the company's checking account to a fictitious person, cash the check, and then place the proceeds in the company's safe for Bobby's use. Through such *sub rosa* means Bobby sidestepped Customs Service requirements that the names and fingerprints of all owners, officers, and employees of a [container freight station] be provided to the Customs Service. Moreover, this clandestine remuneration arrangement enabled Bobby to avoid filing Federal income tax returns or paying taxes for years." Moreover, the new company paid most of Bobby's personal expenses, including his house and automobile. The estate tax return filed by Bobby's personal representative (one of the brothers) did not include any interest in the new company. The Service claimed that Bobby had an ownership interest in the company even though he owned no stock and maintained no bank accounts. Consequently, it assessed a deficiency of over \$11.6 million and imposed a fraud penalty of over \$8.6 million. The simple issue here is whether Bobby died holding an ownership interest in the new company. The Tax Court held he did not. Sure, an individual can be deemed to hold stock in a corporation in which

he or she has a beneficial interest, but whether there's a beneficial interest turns on the facts and circumstances. Here, Bobby never showed an intent to become a shareholder, and the company never showed an intent to make Bobby an owner. Bobby was worried his creditors might attempt to collect on their debts if they discovered he owned any assets, and he was worried that his criminal past might stigmatize the new company. Bobby had no financial reason to be a shareholder instead of an employee—his compensation package was certainly sufficient! Similarly, given Bobby's financial irresponsibility, it made sense that the company would not want him as a shareholder. Although Bobby had a leadership role in the company, it does not follow that he had an ownership interest that would warrant inclusion in his estate. *Estate of Fortunato v. Commissioner*, T.C. Memo. 2010-105 (May 12, 2010).

Section 2035: Adjustments for Certain Gifts Made Within 3 Years of Decedent's Death

Gift Tax Paid by Donees Still Included in Donor's Gross Estate. The decedent and her spouse created a revocable living trust in 1991. The trust provided that upon the death of the first spouse, his or her share of the community property would be used to fund a residual trust that provided a qualified income interest to the surviving spouse. Upon the death of the surviving spouse, the remainder would be paid to their children and grandchildren. The decedent's husband died in 2000, so the residual trust was funded with his share of the community. Sure, the decedent and some of the remainder beneficiaries effected partial disclaimers of interests in the trust, but the trust was still eligible for a QTIP election. Not surprisingly, then, the husband's estate tax return made a QTIP election with respect to the property passing to the residual trust. In December, 2000, the trustees of the residual trust successfully petitioned a state court to split the trust into two trusts. That same month, the decedent conveyed her income interest in one of the two trusts to the remainder beneficiaries. In January, 2001, she made a similar conveyance of her income interest in the second trust. Prior to each transfer, the remainder beneficiaries agreed to pay the related gift tax attributable to these transfers, as both were gifts under § 2519. The remainder beneficiaries paid gift tax of almost \$10 million. The decedent died in August, 2002 (perhaps after someone showed her the gift tax return), within three years of the payment of the gift tax. Her estate tax return, however, did not include the tax paid on the 2000 and 2001 gifts, because the executor claimed that § 2035(b) did not apply. The Service, of course, determined that the gift tax should have been included in the decedent's gross estate and, thus, issued a deficiency notice. The Tax Court, in a reviewed opinion without dissent, agreed with the Service, holding that because of the QTIP election, the decedent is deemed to be the donor of the trust's assets. Accordingly, gift tax from the transfer of QTIP is the decedent's liability, not that of the remainder beneficiaries. "We agree that Congress intended that as between QTIP recipients and the surviving spouse, it is the QTIP recipients who should bear the ultimate financial burden for transfer taxes. However, we do not believe that by allocating the financial burden for gift tax to recipients of QTIP, Congress shifted to them liability for the gift tax. Section 2207A(b) does not provide that the donees of QTIP should be liable for the applicable gift tax. Rather, section 2207A(b) refers to the right to recover the gift tax. The estate's argument would read section 2207A(b) out of the gift tax architecture." The court cited authority that the gift tax paid by the donee of a "net gift" is included in the gross estate of the donor under § 2035(b) if paid within three years of the donor's death. The donee's payment of tax under § 2207A, said the court, is no different. The court concluded, "We recognize the limited economic nature of the interest in QTIP held by the surviving spouse. Nevertheless, the QTIP election that the executor of the estate of the first spouse to die may make carries both benefits and burdens for both spouses and their estates. Inclusion of the gift tax paid with respect to a section 2519 transfer in the surviving spouse's gross estate is one such burden if the transfer occurs within 3 years of his or her death. Without a clear legislative mandate to except gift tax liability of the surviving spouse on section 2519 transfers from the application of section 2035(b), we shall not infer such an exception." *Estate of Morgens v. Commissioner*, 133 T.C. No. 17 (December 21, 2009).

Section 2036: Transfers with Retained Life Estate

Death Doesn't Stop Formation and Funding of Family Partnership. The decedent, Mrs. Williams, was diagnosed with cancer in March, 2000. Around that same time, Mrs. Williams and her advisors discussed the creation of a family limited partnership. Mrs. Williams was “an impeccably shrewd businesswoman and frugal heiress. . . . Of particular concern to Mrs. Williams as she worked to protect the family's interests was the risk of losing control of significant family assets through divorces.” On May 9, 2000, Mrs. Williams signed the documents required to form the partnership and a limited liability company that would serve as general partner of the partnership. The partnership's two limited partners were trusts of which Mrs. Williams was trustee. Mrs. Williams intended to transfer about \$250 million in bonds, securities and cash owned by the trusts to the partnership. (Mrs. Williams would herself still have more than \$110 million of other assets outside of the partnership.) The decedent's advisors then set to filing the necessary paperwork with the state and obtaining tax identification numbers for the new entities. But then, on May 15, 2000, before completion of the partnership's formation and the transfer of assets to the partnership, Mrs. Williams died. Accordingly, her advisors stopped any further action to form the partnership or complete the transfer of assets. Initially taking the position that the partnership had not been created and funded prior to the decedent's death, the estate paid estate taxes of about \$148 million. Thereafter, the decedent's advisors learned at an estate planning seminar that the partnership may have been validly created and funded after all. So they quickly completed formation of the partnership and assignment documents, then got the estate to bring a claim for refund to the tune of about \$40 million plus interest. When the Service did not answer the claim, the estate sued. The district court held that under applicable state law (Texas), “the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership,” and it does not matter whether legal title has been transferred. The court found that Mrs. Williams had entered into an enforceable agreement with her descendants that obligated her estate to go through with the formation and funding of the partnership. Accordingly, the minority interest and lack of marketability discounts claimed by the estate were proper. The district court held that the partnership assets were not includible in Mrs. Williams's estate under either § 2036 or § 2038 because the formation and funding activities constituted a sale for an adequate and full consideration. The transaction constituted a sale, said the court, for a number of reasons. “First, the lengthy discussions that went into creating the Partnership Agreement, which Mrs. Williams signed, provide sufficient objective evidence that the Partnership transaction was ‘real, actual, genuine, and not feigned.’ Second, the primary purpose underlying the Partnership's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This was accomplished by creating an entity that, by altering the legal relationship between Mrs. Williams and her heirs, could facilitate the administration of significant family assets. In other words, the creation and funding of the Partnership was undertaken for a legitimate business purpose and not the mere ‘recycling’ of wealth. Finally, the fact that Mrs. Williams had a significant collection of assets outside of the Partnership—well over \$100 million—further supports the conclusion that the transfer was made pursuant to a bona fide sale.” As for proof that the transaction was for a full and adequate consideration, the court noted several facts: “First, the . . . Partnership Agreement provides that the percentage interests of the partners are proportionate to their respective contributions. The Agreement also sets forth the capital accounts in which the contributions of a partner are credited to the respective capital account of the partner. Finally, the Partnership agreement provides that, upon liquidation, the partners are to receive their capital accounts in accordance with their percentage interests.” Accordingly, the estate's claim for refund was upheld. *Keller v. United States* (S. D. Tex., August 20, 2009).

Decedent's Pledging of Partnership Assets as Security for Personal Loan Indicates Retained Interest, and Lack of Business Purpose Thwarts Discounts. The decedent formed and funded a family limited partnership with \$16.7 million in stock of a single corporation in 1998. In 1999, four months after the decedent had been diagnosed with pancreatic cancer, the partners (the decedent and the trustees of the

two trusts that served as limited partners) authorized the decedent to pledge the partnership assets as security for a personal loan. The decedent promised to repay the debt using personal funds. Two months later, the decedent created a second family limited partnership, this one funded with interests in several family LLCs. The decedent also purportedly made loans to his two children, though not all of the loans were evidenced by promissory notes. A year later, the decedent transferred to the second partnership another, smaller block of stock from the same corporation involved in the first partnership. This block was already serving as security for a personal loan taken by the decedent. The decedent died shortly after this transfer. In reviewing the estate tax return, the Service concluded that the decedent retained possession and enjoyment of the stock contributed to the partnerships for the rest of his life, and that he did not transfer those shares in a bona fide sale for an adequate and full consideration in money or money's worth. Accordingly, it determined that the decedent's estate should include the (undiscounted) value of the stock. The Tax Court agreed, observing that because neither the trustees nor the beneficiaries of the trusts (the limited partners) objected to the decedent's use of the stock to obtain personal loans, there must have been an implied agreement allowing the decedent to make continued personal use of the stock. The court also agreed with the Service that the decedent's transfers of the stock to the partnerships was motivated solely for testamentary and tax benefits, meaning the transfers were not bona fide sales for full and adequate consideration. The Service also maintained that the formation of the second partnership was an indirect gift to the decedent's children because the trusts designated as limited partners were not in existence when the partnership was funded. Here too, the Tax Court agreed. "Because Mississippi State law does not recognize a one-person partnership, [the second partnership] was valid only after the formation of the trusts. Only after [the second partnership] was validly formed on March 1, 2000, could decedent transfer his interests in the ... LLCs to it. Thus, at the time of that transfer, the ... trusts were already limited partners, and they acquired interests in the ... LLCs by virtue of their status as limited partners." The estate argued that the trusts acquired their interests by purchase, pointing to documents evidencing an installment sale of limited partner interests from the decedent to the trusts. But the court agreed with the Service that the sale was a sham. "At the time decedent and the trusts executed the contracts, decedent was terminally ill. Decedent provided all the money for the 10-percent down payments; in effect, the notes constituted the only consideration the trusts gave decedent. ... Petitioners do not explain how decedent's actions comported with an arm's-length sale. Moreover, petitioners offer no evidence, beyond the self-serving testimony of decedent's children, that decedent expected the trusts (or his children) to pay the promissory notes. Given that decedent gave his children the money to pay the interest on the [installment notes], we find their testimony as to the ... promissory notes unconvincing." The court also agreed with the Service that the decedent's payment of debts on behalf of one of the family LLCs was a gift to his children. *Estate of Malkin v. Commissioner*, T.C. Memo. 2009-212 (September 16, 2009).

Strong Evidence of Nontax Reasons for Formation Saved Family Limited Partnership. For 74 years, the decedent was an employee, officer, and director of Erie Indemnity Company, an insurance company. Throughout this time, the decedent acquired Erie stock. A big fan of the company, the decedent rarely sold any shares and made comparatively smaller investments in other companies. Over several years prior to 1993, the decedent made small gifts of Erie stock to his son and to two irrevocable trusts for the benefit of his two grandsons. By 1993, the stock had exploded in value. The decedent became concerned about the amounts previously gifted to his son and the trusts. He thought his son would eventually get divorced and that his daughter-in-law would obtain an interest in at least a portion of the stock. This was suboptimal because her parents frequently had financial problems and turned to their daughter and son-in-law for support. He also feared his grandsons, who were "too close" to their "lazy" mother and in their early 20s without a job, would pull out and sell all of the stock from the trusts when they reached the ages of 25 and 30 (the ages at which each could withdraw corpus from his respective trust). Finally, he lamented the fact that he no longer had enough shares to be a swing vote in the growing feud between the two families that owned the other significant chunks of Erie stock; had the decedent kept all of his shares, he could have sided with the family he supported in the feud. At the

recommendation of his advisors, in 1993 the decedent formed a family limited partnership, to which he contributed all but a small portion of his voting and nonvoting Erie shares. His son contributed all of his shares and, as trustee of both trusts, all of the shares held by the trusts. Everyone received interests in the partnership proportionate to their contributions. The partnership agreement contained very strong transfer restrictions and imposed strict limitations on distributions. Good thing, too—by the time of the decedent’s death in 2001, the stock had grown from about \$80 million in value to over \$318 million. The decedent made a few gifts of partnership interests following formation, including gifts to charity. The decedent died holding a 77% limited partnership interest, and the Service stipulated that the value of this interest was just over \$165 million. But the Service argued that the partnership should be disregarded and that the decedent’s estate should include the assets of the partnership (mostly Erie stock) under § 2036(a). The Tax Court, in a reviewed opinion without dissent, held that the transfer of Erie stock to the partnership was a bona fide sale for adequate and full consideration, so § 2036(a) did not apply. The Service argued that the alleged nontax reasons for creating the partnership were a distant second to the tax benefits sought, but the court concluded that the decedent formed the partnership to provide centralized long-term management of the family’s holdings in Erie stock, to preserve the decedent’s buy-and-hold investment philosophy (as evidenced by the lack of turnover of stock following contribution to the partnership—no stock was sold until years after the decedent’s death), to pool the family’s stock so that it could be voted as a block (key to re-establishing the power of the swing vote), and to protect the stock from creditors and from the son’s divorce (which happened, by the way, in 2004). The Service argued that the partnership should be ignored because it did not operate a functional business operation, the partnership held only passive assets, and the decedent’s son was not substantially involved in the formation of the partnership. But the court cited precedent from 2005 where a partnership with similar flaws survived scrutiny because there were still substantial nontax business reasons for the partnership’s existence. Having determined that the partnership would be respected and that the values stipulated to by the parties would control, the court still had to grapple with a marital deduction issue. The decedent’s spouse died six months after the decedent, before the marital trust provided by the decedent’s living trust could be funded. The living trust provided that assets distributed in kind to the marital trust were to be valued using their date of distribution values. Since the trust was never funded, the estate had to choose a date to use as the date of distribution. It chose the date of the spouse’s death (when the value of a 1% interest in the partnership was about \$2.4 million) instead of the date of the decedent’s death (when a 1% interest was worth about \$2.1 million). The Service argued that the estate made the wrong choice, suggesting that the spouse was entitled to the property as of the date of the decedent’s death. But the court noted that the amount passing to the marital trust “was not ascertainable until [the decedent’s] Federal estate tax liability was known, and, because of the need to appraise the date-of-death value of the principal asset...(his 77.0876-percent class B limited partnership interest...) to compute that liability, that amount was not known on the date of [the decedent’s] death. ... Because the marital trust was to terminate upon [the spouse’s] death, that is the last possible date on which it could have been funded. We agree with petitioner that to pick that date, which is the date closest to what would have been the actual date of the distribution to the marital trust had [the spouse] survived, as the deemed date of funding is logical and reasonable.” *Estate of Black v. Commissioner*, 133 T.C. No. 15 (December 14, 2009).

Timber! Service’s Attack on Partnership Falls Because of Nontax Reasons for Formation. The decedent was one of three children of Charles and Bonnie Barge. The Barges owned over 45,000 acres of timberland in Mississippi, and they regularly gave undivided interests in the land to family members, including the decedent. By 1993, there were 14 family members with interests in the timberland. On the advice of counsel, the family members dumped their undivided interests into a family limited partnership (the Barge Partnership). As the decedent’s brother testified, counsel for the family advised, “You’re going to have a problem because if you make a timber sale, you’ve got to have the signatures of all these people, and he said, your business is not going to function the way it’s set up. And he suggested a partnership, limited partnership.” Shortly after formation of the partnership, the decedent and her siblings saw another attorney for tax and business advice. “They had several concerns, the first of

which was the protection of the family's interest in the Barge timberland. Specifically, because of the 'jackpot justice' that the Barge family members and their spouses believed existed in Mississippi, they were concerned that were they to be sued and a judgment entered against them, they could lose control of the family business." So the new lawyer recommended that each sibling place his or her Barge Partnership interest into a separate limited partnership. The decedent followed that advice, transferring some assets to her husband, Reverend Shurtz, and the two of them placing her partnership interest and about 750 acres of timberland they owned directly into a new family limited partnership (the Doulos Partnership). Eight months after formation, Reverend Shurtz drafted a "project planning note" that claimed "the purpose of the project was to build Doulos L.P. into a functioning limited partnership in order to: 1. Reduce the estate; 2. provide asset protection; 3. provide for heirs; 4. provide for the Lord's work." The Doulos Partnership did not get a bank account until four months after formation, and the entity had a checkered past with distributions (the decedent was the only partner to get a distribution in 1997, she and her husband were the only partners to get distributions in 1999, and in 2000 the decedent received a disproportionately large distribution). Over a five-year period, the decedent made annual exclusion gifts of limited partner interests in the Doulos Partnership to her children. At the time of her death in 2002, the decedent held a 1% general partner interest and an 87.6% limited partner interest. The Service contended that the decedent's estate should include the undiscounted values of the Doulos Partnership's assets under § 2036(a). The Tax Court rejected this argument, finding that because the Doulos Partnership was established for substantial nontax business reasons, the "bona fide sale for adequate and full consideration" exception to § 2036(a) applied. As the court explained, the decedent and her family "had a legitimate concern about preserving the family business and that they established family limited partnerships to address their concerns. Preservation of the family business is a legitimate reason for establishing a family limited partnership. ... We are mindful that the threat to the business must be more than merely speculative. ... [W]e are satisfied that decedent and her family were actually motivated by a legitimate concern regarding the threat of litigation that went beyond mere speculation, that the establishment of family limited partnerships was a customary response in Mississippi to possible lawsuits, and that the Doulos L.P. partnership agreement was designed to limit the exposure of the ownership interests of the partnership (e.g., protection of limited partnership interests from seizure and the automatic conversion of general partnership interests to limited partnership interests). Moreover, the record shows that the establishment of Doulos L.P. facilitated the management of the timberland decedent and her husband contributed to the partnership." So while reducing estate tax was "a motivating factor" in creating the partnerships, the nontax reasons were "actual" and not merely theoretical, leading the court to conclude that the bona fide sale exception applied. Accordingly, there was no estate tax deficiency. *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21 (February 3, 2010).

A Textbook Example of Retained Enjoyment, But Sometimes Courts Don't Read Textbooks.
The decedent signed a deed in May, 2000, that conveyed a 49% tenancy-in-common interest in New York City property to her son. The decedent and her son resided on the first two floors of the property, and the remaining three floors were leased to an unrelated business that paid rent of \$9,000 per month. The deed was misplaced by the closing company and not recorded until April, 2001, five months after the decedent's death in November, 2000. The decedent's executors filed a gift tax return to report the gift to the son and included the decedent's 51% interest in the property on the estate tax return. The Service assessed separate notices of deficiency, claiming first that the decedent's gift to her son was incomplete as of the date of her death because the deed had not yet been recorded. The Tax Court held the gift was complete because New York law does not depend on recordation of a deed for a transfer to be complete. The Service then argued that the entire value of the property was includible in the decedent's gross estate under § 2036(a)(1) because she continued to reside at the property and received all of the rental income from the commercial tenant. The court agreed, holding that the decedent's receipt of the rental income was sufficient to trigger inclusion in her gross estate of the full value of the property. (No mention is made of the impact of her retained occupancy of the property, likely because her retained rights in 100% of the rental income were sufficient to reach its holding.) The estate argued that there was an agreement

between the decedent and her son to split the profits from the rents at some future point, but the court found the testimony on this point lacked credibility. The estate also argued that it should be entitled to deduct all of the property taxes related to the property even though they were paid by the son. The court held that because the taxes were not due until after the decedent's death, no deduction was permitted. On appeal, a divided Second Circuit vacated the Tax Court's decision and remanded the case for further findings of fact. The appellate court was unconvinced that the Tax Court sufficiently indicated the decedent's retained interest in 100% of the property. Certainly there was no evidence of any implied agreement that the decedent would retain enjoyment of "the residential portion" of the son's 49% interest. "Decedent did not have exclusive possession of, nor did she exclude [her son] from, [his] 49% interest in the Manhattan property—or, for that matter, the entire property. ... [W]here, as here, the Tax Court has made no specific findings relating to enjoyment of the residential portion of the property, and the Commissioner points to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning the residential portion cannot stand." But the Second Circuit held that the Tax Court was not erroneous in finding "an implied agreement that Decedent would enjoy for her life the substantial economic benefit of some part—indeed, perhaps all—of the rental portion of the Manhattan Property." Still, it needed to remand the case to determine "the extent to which Decedent enjoyed the substantial economic benefit of [the son's] 49% interest during her life. And, because the Tax Court did not consider 'all facts and circumstances surrounding the transfer and subsequent use of the property,' it is appropriate to vacate and remand so that the Tax Court may do so." Writing in dissent, Judge Livingston observed that the majority "does not—and cannot—explain how the Tax Court clearly erred as a factual matter in concluding that [the decedent] retained all these benefits, given that her relationship to the property changed in *not one significant respect* from the period preceding transfer to the period after. Instead, the majority, misreading a body of case law that primarily involves transfers of 100% of a family member's interest in a property to another family member, concludes that post-transfer co-occupancy is near-conclusive evidence that the transferor can no longer enjoy the substantial economic benefits of residence to the extent of the transferred interest. Indeed, the majority finds such co-occupancy dispositive even here, where the transfer concerned only a fraction of the transferor's interest, created a tenancy in common that guaranteed the transferor continued access to the entirety of her property, and involved a transferor and transferee who the majority agrees were found *correctly* by a court of law to have reached an agreement undercutting the economic substance of the very transfer under consideration. This turns the proper—and longstanding—construction of section 2036 on its head. It also opens up a loophole that will vitiate to a considerable degree the efficacy of this section...." *Estate of Stewart v. Commissioner* (2d Cir., August 9, 2010).

Section 2053: Expenses, Indebtedness, and Taxes

Final Regulations Limit Deduction to Claims Actually Paid, But Offer Two Helpful Exceptions. In 2007, Treasury issued proposed regulations regarding the § 2053 deduction for claims against the estate. Prior to the proposed regulations, some courts permitted the § 2053 deduction to be computed using the value of the claim as of the decedent's death without regard to whether the claim has been settled or resolved by litigation and without regard to the amount actually paid by the estate. Thinking it's wrong to force a "re-trial" of the value of the claim in a tax proceeding when the amount of the claim has already been set by events occurring after death, Treasury proposed regulations under § 2053 providing that post-death events are to be considered when determining amounts deductible under § 2053. Specifically, the proposed regulations limited the § 2053 deduction to amounts actually paid by the estate in satisfaction of deductible claims and expenses. These regulations have now been finalized, but the final regulations contain two exceptions to the requirement that the claim be actually paid. First, "if a decedent's gross estate includes a particular asset and there are one or more claims against the decedent's estate integrally related to that particular asset," the estate may deduct the current value of the claim even though it has not been paid, provided: (1) the claim would otherwise be deductible and was existing at the

time of the decedent's death; (2) the value of the claim is determined by a "qualified appraiser" (using the same definition as for charitable contributions under § 170); and (3) the aggregate value of the related assets included in the decedent's gross estate exceeds 10% of the value of the decedent's entire gross estate. Any post-death events can cause the value of the claim to be adjusted. Second, the final regulations include an exception for claims against the estate that, collectively, do not exceed \$500,000 (not including those deductible as ascertainable amounts under the first exception). The regulations also provide that an estate may not claim a deduction for any claim that is potential, unmatured, or contested when the estate tax return is filed. A final court decision will be determinative in establishing both the amount and enforceability of a given claim or expense if the court made or reviewed fact findings upon which the deduction depends. Settlement agreements will be determinative if they were the result of bona fide negotiations between adverse parties (the final regulations delete the added requirement that the settlement amount be consistent with the range of reasonable outcomes under applicable state law). Estates may file protective claims for refund to preserve their rights if the amount of a liability is not ascertainable by the time of the statute of limitations for refund claims expires. Deductions are not allowed for claims or expenses that are compensated for by insurance or otherwise reimbursed. The final regulations further provide that if the estate is one of many defendants to a particular claim, the estate may deduct only its portion of the liability. While the proposed regulations stated that claims by beneficiaries or family members will be strictly scrutinized to ensure legitimacy, the final regulations back off to some extent, providing instead that such claims be bona fide. The final regulations confirm that if a claim becomes unenforceable after the decedent's death, no deduction will be permitted. If a claim represents the decedent's debt to make recurring payments, the estate can claim a deduction only as payments are made, which means that if the obligation will extend beyond the statute of limitations for refund claims, the estate will have to file a protective claim for refund. The regulations will apply to estates of decedents dying on or after October 20, 2009. *Regulation §§ 20.2053-1(b) and 20.2053-4* (October 20, 2009).

Service Will Limit Review of Returns Based on Protective Refund Claim. In connection with the final regulations discussed above, one commentator expressed concern that a protective claim for refund would effectively extend the statute of limitations, for if the estate later made a refund claim pursuant to the protective claim, the Service could reexamine the entire estate tax return. Treasury has announced that in processing a timely-filed protective claim for refund of tax based on a § 2053 deduction, if the claim for refund ripens after the expiration of the normal period of limitations on assessment, the Service will limit its review of the estate tax return only to the evidence relating to the § 2053 deduction that was the subject of the protective claim. Treasury predicted that because the final regulations provide two exceptions to the general rule that a deduction for a claim or expense is limited to the amount paid in settlement or satisfaction of such claim or expense, the number of protective refund claims filed to preserve § 2053 deductions "will be significantly smaller than was anticipated by commentators to the proposed regulations." Nonetheless, the announced policy of limited review should be of comfort to practitioners. *Notice 2009-84* (October 20, 2009).

Section 2055: Transfers for Public, Charitable, and Religious Uses

No Charitable Deduction for Portion of Remainder Paid to Charitable Trust Under Settlement Agreement. Despite three codicils, the decedent's will failed to provide for the disposition of the residuary estate. Oops. The will established trusts for the lives of certain individual beneficiaries, with the remainders of the trusts passing to a charitable trust. The decedent's only child claimed he was entitled to the residue, but the charitable trust claimed it was the lawful beneficiary of the residue and that the omitted residuary clause was the result of scrivener's error. An affidavit from the attorney who drafted the decedent's will states that the decedent's intent was for the residue to pass to the charitable trust. This was evidenced by prior wills that left the residue to the charitable trust, together with the

decedent's history of large charitable gifts *inter vivos*. The decedent's child and the charitable trust finally settled their dispute after several months. Under the settlement, the son would get a fixed amount of cash and the balance was to be paid to the charitable trust. The issue plaguing the Service was whether the decedent's estate could claim a charitable contribution deduction for the amount of the residue passing to the charitable trust. The Service ruled that the estate was not entitled to a deduction. Applicable authority indicates that in order to claim a § 2055 deduction for an amount paid to charity under a settlement agreement, the charity must have had an enforceable right under state law to receive the payment. In this case, said the Service, it is not clear that the charitable trust would have been entitled to any portion of the decedent's residue because there was no clause disposing of the residue. "The will does provide for the distribution of certain trust remainders to Charitable Trust, and the Charitable Trust is the taker in the event the *in terrorem* clause becomes operative. However, we cannot conclude that these provisions addressing bequests other than the residue, 'expressly or by clear implication discloses the intention of the testator that the courts may carry it out.' We also note that the relative amounts Son and Charitable Trust received under the Settlement is not indicative of whether Charitable Trust had an enforceable right under Decedent's will. Arguably, Son may have settled ... in order to avoid lengthy litigation and the additional expense litigation would entail." *Technical Advice Memorandum 201004022* (January 29, 2010).

Section 2103: Definition of Gross Estate

It's a Little Late to Elect Community Property Status. Noordin and Roshankhanu were born in Uganda and were citizens of the United Kingdom (because Uganda was a British protectorate until it became independent in 1962). They married each other there in 1967. They were exiled from Uganda by Idi Amin in 1972 and moved to Belgium, where they were domiciled at all times. In 1997, Noordin bought some shares in Citicorp and kept them at the Hong Kong branch of a Belgian bank. That stock became Citigroup, and by the time of Noordin's death in 2002, the value of the stock was \$11,790,000 (six months later, they were worth \$8,312,500). The estate tax return elected to use the alternate valuation date. It treated the Citigroup stock as community property, and this included only a one-half interest in the stock in Noordin's gross estate. That struck the Service as odd, for Uganda does not recognize community property, and while Belgian law permits couples to agree as to the status of property, Noordin and Roshankhanu never executed any documents that would have clarified the classification of their assets. So the Service said the entire block of stock should be in Noordin's estate. (This mattered because Roshankhanu was not the sole beneficiary of Noordin's estate.) The Tax Court observed that Belgian law determines the status of property. As the court explained, "under Belgian conflict of laws principles, the ownership of matrimonial property is governed by the law of the common nationality of the spouses, in this case the law of the United Kingdom, [so] the key question for decision is whether an English court in this case would follow the doctrine of immutability, under which the question whether property is held as community property turns on the law of the parties' domicile at the time of marriage, or the doctrine of mutability, under which the question turns on the law of the parties' domicile at the time of the decedent's death[.] [I]f the immutability doctrine applies, ownership of the Citigroup shares continued to be governed by English substantive marital property law even after the move of Decedent and his spouse to Belgium, and Petitioners must lose this case because Decedent and his spouse did not formally change their marital regime under the procedures prescribed by the Belgian Code Civil; if, on the other hand, the doctrine of mutability applies, Petitioners win, because the exile of Decedent and his spouse from Uganda and their arrival in Belgium with the intent to remain there permanently brought them as a matter of law under Belgium's community property regime, with no need to follow the Code Civil formalities." The court found English precedent applying the immutability doctrine, but the estate argued that the case law is distinguishable because it says nothing about the circumstances of forced exile. It argued under an implied contract theory that in changing their domicile, Noordin and Roshankhanu effectively elected into the law of their new domicile, meaning that Belgium's

principles of matrimonial property could apply. The court rejected this argument, finding that the estate “neither provided persuasive authority nor proposed a workable rule as to when mutability becomes effective. They have not cited any law suggesting that the earnings of decedent from which the shares were purchased were community income under the laws of Belgium. There are no objective criteria for determining that a change in the character of their marital property occurred and, if so, whether it took effect immediately or 5, 10, or 20 years after decedent and [Roshankhanu] left Uganda. The only objective evidence is that the Citigroup shares were acquired and held solely in decedent’s name in 1997, approximately 25 years after the move to Belgium.” Accordingly, the entire block of stock was included in Noordin’s gross estate. The estate made the same arguments before the First Circuit on appeal, but that court affirmed, essentially adopting the analysis of the Tax Court. The appellate court did reverse as to the application of a late-filing penalty. (The Service had originally assessed a penalty of about \$290,000 for the late filing but then increased the penalty to just over \$800,000 when it adjusted the amount included in Noordin’s gross estate.) The Service originally abated the initial penalty after determining there was good cause for the failure to file a return timely, but it refused to abate any portion of the \$511,000 increase. The First Circuit determined that the failure to abate the subsequent increase was wrong. “The whole is but the sum of its parts, and logically, the two portions of the late-filing penalty should stand or fall together. There may be special circumstances that would justify splitting the baby, but the Commissioner has the burden of identifying those circumstances. Absent a plausible explanation, the only conclusion that can be drawn from the abatement of the initial portion of the penalty is that the remainder of the penalty should have been abated as well. Any other result would be arbitrary, capricious, and in derogation of the government’s duty to turn square corners in dealing with taxpayers.” *Estate of Charania v. Commissioner* (1st Cir., June 17, 2010).

Section 2503: Taxable Gifts

You Don’t Get Annual Exclusions for Gifts of Family Partnership Interests, But That’s Not All Bad. In 1997, the taxpayers created a family limited partnership and funded it with stock in a closely-held equipment distribution corporation and three parcels of commercial land leased to the corporation and another company. The partnership interests were initially held by a corporate general partner and two revocable living trusts that served as limited partners. In 1998, the partnership sold the equipment company stock and used the proceeds to invest in marketable securities. Over the course of six years, the taxpayers made gifts of limited partnership interests to their three adult children. At the end of the gifting spree, each child had a 33% limited partner interest. On their federal gift tax returns, the taxpayers claimed annual exclusions for each of the gifts, together with “substantial discounts for lack of control and lack of marketability of the transferred partnership interests.” The Service issued deficiency notices for each of the years in question on the grounds that the gifts were of future interests and thus ineligible for the annual exclusion. The Service observed that the partnership agreement barred transfers of limited partnership interests to third parties and limited partners had no power to compel distributions (the agreement did not even provide for mandatory distributions to cover taxes). Before the Tax Court, the taxpayer argued that the interests were freely transferrable between partners or to the general partner. But the Tax Court held that “contingencies stand between the donees and their receipt of economic value for the transferred partnership interests so as to negate finding that the donees have the immediate use, possession, or enjoyment of the transferred property. Pursuant to ... the partnership agreement, unless all partners consented the donees could transfer their partnership interests only to another partner or to a partner’s trust. In addition, any such purchase would be subject to the option-to-purchase provisions ... of the partnership agreement, which gives the partnership itself or any of the other partners a right to purchase the property according to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer.” So while the Service did not challenge the discounts claimed on the gift tax returns, the taxpayers lost out on the ability to claim an annual exclusion because they could not show that the gifts of partnership interests gave the recipient an

“unrestricted and noncontingent right to immediately use, possess, or enjoy either the property itself or income from the property.” *Price v. Commissioner*, T.C. Memo. 2010-2 (January 4, 2010).

It’s Déjà vu All Over Again! No Annual Exclusion for Gifts of Really Limited Limited Liability Company Interests. The taxpayers, mother and father, transferred a parcel of Michigan lakefront property to an LLC. Over the course of three years, the taxpayers gave 4.762% interests to each of their seven children. They claimed the annual exclusion for each of these gift transfers, but the Service assessed gift tax deficiencies on the grounds that the LLC interests were not gifts of “present interests.” Sure enough, the LLC’s operating agreement provides that the timing and amount of all distributions is to be determined by the entity’s general manager; no other member can compel a distribution for any reason and no distributions are required. Holders of an LLC interest are permitted to transfer only a profits interest in the LLC, and the entity has a right of first refusal before any such transfer can take place. For these reasons, said the Service, the kids are not “entitled unconditionally to the present use, possession, or enjoyment of the property transferred,” meaning they have received future interests. The taxpayers argued the kids had present interests because each had “the unrestricted right to receive distributions,” but the court reasoned that this right did not mean much given that all discretion with regard to distributions lay with the general manager. The taxpayers then argued the kids had present interests because they had the right to use the lakefront property. The court could not find this right in the operating agreement, but it concluded that even if the kids had this right as members of the LLC, “the right to possess, use, and enjoy property, without more, is not a right to a ‘substantial present economic benefit.’” Finally, the taxpayers argued that the kids could sell their interests, but the court determined that the limitation on selling only a profits interest, coupled with the entity’s right of first refusal, meant it was impossible for the kids “to presently realize a substantial economic benefit.” Accordingly, none of the gifts qualify for the annual exclusion. *Fisher v. United States* (S.D. Ind., March 11, 2010).

Section 2511: Transfers in General

Swap Power Does Not Cause Transfers to Trust to be Incomplete Gifts, and Does Not Cause Gross Estate Inclusion. The taxpayer intends to create a standard irrevocable trust, retaining a power to substitute trust assets with other properties. The power is exercisable in a nonfiduciary capacity, but can only be exercised if the taxpayer certifies in writing that the acquired property and the substituted property are of equivalent value and only if the trustee is satisfied that the properties acquired and substituted are in fact of equivalent value. The taxpayer’s power to swap assets will not be exercisable in a manner that could shift benefits among the beneficiaries of the trust. We know from established authority that the taxpayer’s retention of this swap power will not cause inclusion in the grantor’s gross estate, although it will cause the trust to be treated as a grantor trust for federal income tax purposes. But will the swap power prevent any transfers from the taxpayer to the trust from being completed gifts? The Service ruled it would not, for a swap power is neither a power to “revest” beneficial title to the property back in the taxpayer’s hand nor a power to name new beneficiaries or to change the interests of the beneficiaries as between themselves. So any transfer to the trust by the taxpayer will be a completed gift. The Service also confirmed that the swap power would not cause inclusion of the trust assets in the taxpayer’s gross estate. *Private Letter Ruling 200944002* (October 30, 2009).

Disclaimer Into Charitable Lead Trust Thwarts Charitable Deduction if Disclaimant Retains Contingent Remainder Interest, But Fixed-Dollar Disclaimer Directly to Charity Okay. The decedent’s will left her entire estate to her daughter. The daughter disclaimed a portion of the bequest (the disclaimed portion represented all amounts over \$6.35 million in value “as finally determined for federal estate tax purposes”). The decedent’s will provided that any disclaimed amounts would pass 25% to a charitable foundation and 75% to a charitable lead trust that would pay an annuity of 7% to the foundation for 20 years with the remainder to pass to the daughter if she was then living. The daughter did not

disclaim this contingent remainder interest. The estate tax return claimed a charitable deduction for the amount passing directly to the foundation and for the present value of the foundation's lead interest in the charitable lead trust. The Service disallowed a deduction for any amount passing to the lead trust because the daughter failed to disclaim the contingent remainder interest in the lead trust. While "partial disclaimers" are expressly permitted under § 2518(c)(1), they must still meet the requirement in § 2518(b)(4) that the disclaimed interest pass "to a person other than the person making the disclaimer." The Service concluded that by retaining her contingent remainder interest, the daughter effectively disclaimed the interest to herself. Regulation §25.2518-2(e)(3) requires that a disclaimed interest must "pass completely" to another person in order to be an effective disclaimer, and since there is a chance that the daughter can take under the lead trust, said the Service, the disclaimer was ineffective. The regulation even states that "if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed." Before the Tax Court, the estate acknowledged that the regulation was valid but argued that the contingent remainder interest was either "severable property" or "an undivided portion of the property." The Tax Court (12-2) rejected these arguments and held for the Service. The contingent remainder was not severable property because it could not be divided into separate parts that would maintain complete and independent existences. The court observed, for example, that a block of stock can be severed into individual shares, but an intangible right cannot be severed into present and remainder interests because each such interest has very different rights and characteristics. Furthermore, the contingent remainder was not an "undivided portion" of the property disclaimed because it was not a "fraction or percentage of each and every substantial interest or right owned by disclaimant." So while the daughter could have disclaimed 40% of the entirety, she could not disclaim only the lead interest and retain a remainder interest. The estate also argued that the savings clause in her written disclaimer should be given effect because it reflects an intent to do whatever was required to make an effective disclaimer. The court would not do so, concluding that it blatantly contradicts what the rest of the document does (impermissibly disclaim only a lead interest) and that even if it were given effect, it would either be coming more than 9 months after the bequest or it would fail to unqualifiedly identify the property being disclaimed. In dissent, Judge Swift argued that the regulation only invalidates that portion of the disclaimed interest to which the daughter retained an interest. In other words, the daughter's failure affected only her contingent remainder and not the foundation's lead interest. In addition, he concluded that the contingent remainder was severable from the lead interest because both interests could exist independently of each other. Accordingly, he would have permitted the charitable deduction. As for the amount passing directly to the foundation, the Tax Court permitted a deduction. That sent the Service to the Eighth Circuit, where it argued that because the final value of the estate was not finally determined at the time of the decedent's death, but only after a partially successful challenge by the Service, the transfer to the foundation was, ultimately, "dependent upon the performance of some act or the happening of a precedent event" (namely, the Service's challenge against the return and the subsequent settlement process) in violation of Regulation § 20.2055-2(b)(1). The Eighth Circuit rejected this argument, concluding that the only uncertainty remaining after the disclaimer was the value of the estate (and, thus, the amount of the deduction). As the court observed, "the Commissioner fails to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death." The Service also argued that the daughter's use of a fixed-dollar disclaimer should be void on public policy grounds because there's no financial incentive for the Service to challenge valuation positions taken on the estate tax return. But the court rejected this argument too, noting that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." The court found this rule of construction unnecessary because the estate's fiduciaries already have an incentive to value assets properly. As the court explained, "with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that

the executor or administrator does not under-report the estate's value. Such beneficiaries, therefore, have an interest in serving a watchdog function.” The court thus affirmed the Tax Court’s decision. *Estate of Christiansen v. Commissioner* (8th Cir., November 13, 2009).

Formula Clause Respected, and Added Gifts to Charities are Deemed to Occur at Time of Original Transfers. In 1982, the decedent inherited a large block of UPS stock from her uncle. She transferred the stock to a family LLC. The decedent reserved a fixed number of ownership units in the family LLC for herself (including all of the voting units), assigned (through gift and sale transactions) a fixed dollar amount of the remaining units (with a combined value of about \$9 million) to two trusts for the benefit of two of her children, and gave the remainder to two charities, the Seattle Foundation and the Kitsap Community Foundation. When the Service determined that the value of the family LLC was higher than first claimed on the gift tax return that reported the transfers, the Tax Court had to decide whether to honor the formula clause used by the decedent and allocate more shares to the charities. The decedent “claims that she gave stock to her children equal in value to her unified credit and gave all the rest to charity. The Commissioner claims that she actually gave a particular number of shares to her children and should be taxed on the basis of their now-agreed value.” The court held that the decedent used an effective formula clause, not a void savings clause. “The plain language of the documents shows that [the decedent] was giving gifts of an ascertainable dollar value of stock; she did not give a specific number of shares or a specific percentage interest in the [family LLC]. Much as in *Christiansen*, the number of shares given to the trusts was set by an appraisal occurring after the date of the gift.” Having determined that the formula clause was valid, the court had to tackle a second issue. As the court explained, “[t]he question is how to measure the size of the gift on which tax is owed: We have to multiply the new value of the shares by the number of shares going to the charities, but is it the number of shares before or after the reallocation?” The decedent wanted to deduct the entire amount eventually passing to the charities on the 2002 gift tax return, but the Service argued that only the units actually passing in 2002 should be deductible on that return; units passing later because of the revaluation should be deducted on a later return. The court adopted the decedent’s position: “In the end, we find it relevant only that the shares were transferred out of Anne’s name and into the names of the intended beneficiaries, even though the initial allocation of a particular number of shares between those beneficiaries later turned out to be incorrect and needed to be fixed.” *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280 (December 7, 2009).

Service Clarifies (to Some Extent) the Scope of “New” § 2511(c). Although it was promulgated in 2001, § 2511(c) became effective as of January 1, 2010. The entire text of § 2511(c) reads as follows: “Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift unless the trust is treated as wholly owned by the donor or the donor’s spouse under subpart E of part I of subchapter J of chapter 1.” That appears to say that any transfer to a trust shall be treated as a gift unless the trust is a grantor trust. That leads to two additional interpretations: (1) No transfer to a grantor trust is a gift; and (2) A sale of property to a grantor trust is not a gift, but a sale to a nongrantor trust *is* a gift even though the trust is paying adequate and full consideration. No wonder practitioners were nervous about the implications of this “new” rule. The Service has debunked the first interpretation (that no transfer to a grantor trust can be treated as a gift), declaring that “Some taxpayers may have inaccurately interpreted § 2511(c) as excluding from the gift tax transfers to a trust treated as wholly owned by the donor or the donor’s spouse ... even though those transfers would otherwise be taxable under Chapter 12. The provisions of Chapter 12 regarding the substantive law applicable to the gift tax ... continue to apply to all transfers made by donors during 2010. Section 2511(c) is an addition to those substantive law provisions and is applicable to transfers made in 2010. Section 2511(c) broadens the types of transfers subject to the transfer tax under Chapter 12 to include certain transfers to trusts that, before 2010, would have been considered incomplete and, thus, not subject to the gift tax. Accordingly, each transfer made in 2010 to a trust that is not treated as wholly owned by the donor or the donor’s spouse ... is considered to be a transfer by gift of the entire

interest in the property under § 2511(c). The provisions of Chapter 12 as in effect on December 31, 2009, continue to apply (both before and during 2010) to all transfers made to any other trust to determine whether the transfer is subject to gift tax.” Rats. But what about the second interpretation (that a sale to a nongrantor trust will nonetheless be treated as a gift transfer)? Ominously, the Service is silent on this point. Given the stated intent of § 2511(c) is to discourage taxpayers from using nongrantor trusts as a tactic for taking multiple rides up the graduated income tax brackets, it is unlikely the Service would take the position that a transaction that is in substance a sale should be characterized as a gift transfer. But it would have been nice for the Service to say that. *Notice 2010-19* (February 2, 2010).

Tax Court Gives Regard to Transfer of Interests in Disregarded Entity, But Step Transaction Doctrine Applies. The taxpayer transferred \$4.25 million in cash and publicly-traded stock to a New York limited liability company in exchange for all of the equity interests in the entity. Because the taxpayer held all of the interests in the LLC, of course, it was a “disregarded entity” under the check-the-box regulations. Twelve days later, the taxpayer gifted a 9.5-percent interest in the LLC to each of two trusts created for the benefit of her son and granddaughter. After the gift to each trust was complete, the taxpayer sold a 40.5-percent interest in the LLC to each trust in exchange for a promissory note. On her gift tax return reporting these transfers, the taxpayer claimed an aggregate 36.55-percent discount for lack of control and marketability, meaning she paid no gift tax on the transfers. The Service determined that the transfers should be treated as though the taxpayer transferred the underlying assets of the LLC because the LLC was a disregarded entity. After all, if we are supposed to pretend that the entity does not exist, we must do so consistently, which means here that the taxpayer transferred portions of the underlying assets and not minority interests in a nonmarketable, closely-held entity. The Tax Court held (10-6) that for gift tax purposes, the LLC is not disregarded, meaning the taxpayer’s transfers are to be valued as transfers of interests in the LLC and not as transfers of the underlying assets. Although federal tax law may disregard the entity, reasoned the majority, state law does not. And “[a] fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights. . . . Consequently, pursuant to the historical Federal gift tax valuation regime, [the taxpayer’s] gift tax liability is determined by the value of the transferred interests in [the] LLC, not by a hypothetical transfer of the underlying assets of [the] LLC.” The court held that the promulgation of the check-the-box regulations did not alter this approach long used for gift tax purposes. “While we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes.” The dissenters generally believe that if the LLC is supposed to be disregarded for all tax purposes, as the plain language of the check-the-box regulations requires, then the LLC’s assets and activities are imputed directly to the owner, meaning in this case that the taxpayer effectively conveyed undivided interests in the underlying assets to the trusts. They contend that the majority’s interpretation effectively invalidates the check-the-box regulations for federal gift tax purposes. In the reviewed opinion, the court did not express an opinion as to the claimed valuation discount or whether the step transaction doctrine applied. In a subsequent memorandum decision, however, the court held that the step transaction doctrine applied to collapse the gift and sale transfers into two gifts of 50% interests in the LLC to the extent the value of these interests exceed the value of the notes received from the trusts. While there may have been nontax reasons for establishing the LLC, the court found no nontax reason for separating the gift and sale transfers. On top of that, all of the gift and sale transfers occurred on the same day, and the taxpayer’s attorney recorded the transfers as two gifts of 50% interests. Having decided that the taxpayer made two gifts of 50% interests, the court could turn to

the valuation issue. Not surprisingly, a 50% interest would receive a smaller discount than a 9.5% interest and a 40.5% interest. The minority interest discount was reduced to eight percent because the owner of a 50% interest could, for example, block the appointment of a new manager. The court upheld the claimed 30% marketability discount, but that's not especially significant because the Service did not even challenge this discount. In the end, the taxpayer received a 35.6% discount. *Pierre v. Commissioner*, 133 T.C. No. 2 (August 24, 2009); *Pierre v. Commissioner*, T.C. Memo. 2010-106 (May 13, 2010).

Section 2512: Valuation of Gifts

Fractional Interest Discounts on Transfers of Vacation Home to Qualified Personal Residence Trusts Upheld. The taxpayers, a married couple, owned a \$7.25 million vacation residence on the Big Island of Hawaii. Each spouse created a separate qualified personal residence trust to which each spouse contributed a one-half interest in the home. In computing the value of the gifted remainder interest, the taxpayers claimed a 30% fractional interest discount from the value of one-half of the property. The Service determined that the maximum discount should have been 15%, so it determined that the taxpayers owed gift tax. When the matter got to the Tax Court, the Service took the position that a maximum discount of 11% should be applied. The court ultimately approved a 17% discount. How, you ask? Simple. The court found that a willing buyer of a one-half interest would expect that about ten percent of the time, a partition of the property would be necessary. Any such partition action would likely take two years to complete. The court determined the present value of a one-half interest would be \$3,037,500 where no partition action was necessary and \$2,663,388 in the ten percent of cases where a partition action would be necessary. The weighted average of these two amounts suggests a buyer would have been willing to pay \$3,000,089 for a one-half interest, and that's equivalent to a 17% discount. *Ludwick v. Commissioner*, T.C. Memo. 2010-104 (May 10, 2010).

Section 2601: Tax Imposed

Again, Don't Let Those General Powers of Appointment Over Grandfathered Trusts Lapse. The decedent held a general power of appointment over an irrevocable trust created under her husband's will. The decedent died in 1998, never having exercised the power. By default, some of the assets from the trust passed to other relatives of the husband, and some of those beneficiaries are skip persons. Because the trust was created in 1968 (before the enactment of the generation-skipping transfer tax), it was grandfathered from the GST tax. Nonetheless, the Service alleged that the decedent's estate owed over \$4 million in GST tax because, under Regulation § 26.2601-1(b)(1)(v)(A), a transfer resulting from a lapse of a general power of appointment over a grandfathered trust is treated as a constructive addition to that trust. That's bad news because the grandfathering exemption does not apply to generation-skipping transfers made from principal added to a grandfathered trust after September 25, 1985. If the decedent's lapse of a general power of appointment is treated as a constructive addition of the entire trust principal, then the GST tax applies. In a 2007 decision, the Sixth Circuit upheld the regulation as a reasonable interpretation of the ambiguous grandfathering exemption, so the decedent's estate had an uphill task trying to convince the court that it should receive the refund requested. Indeed, the district court held that the regulation was valid and applied to the decedent's lapse in this case. On appeal, the estate argued that the regulation's concept of a "constructive addition" goes beyond the scope of the statute because the term "added" in the grandfathering exemption should be limited to additions from an outside source and not from the mere lapse of a power of appointment. But the Sixth Circuit affirmed the decision of the district court, finding Treasury's expansive view of "added" to include constructive additions appropriate given "congressional intent that the grandfathering exemption apply 'only in those cases where the generation-skipping transfer could not be avoided.'" As to whether the lapse of a general power of appointment is a constructive addition to the trust, the court was clear: "A constructive addition occurs

when (1) a portion of a trust remains in the trust after the post-September 25, 1985 release, exercise, or lapse of a power of appointment over that portion of the trust, and (2) the release, exercise, or lapse is treated as a taxable transfer in the estate and gift provisions of the tax code. The first requirement is met because trust assets remained in the trust after the payment of [the decedent's] estate taxes attributable to the inclusion of trust property in her estate. The second requirement is met because, as the parties stipulated, [the decedent's] estate paid estate taxes '[b]ecause of the general power of appointment over the Trust property.' Therefore, the trust assets are 'treated as if [they] had been withdrawn and immediately retransferred to the trust at the time of the . . . lapse [of the general power of appointment],' and because these transfers occurred after the effective date of the GST tax, the subsequent transfers of trust assets to her grandnieces and grandnephews are subject to the GST tax." *Estate of Timken v. United States* (6th Cir., April 2, 2010).

Section 2702: Special Valuation Rules in Case of Transfers of Interests in Trusts

Modification to QPRT to Permit Reverse QPRT Does Not Trigger § 2702. In a series of rulings, the Service has given a partial blessing to a technique whereby qualified personal residence trusts are modified to give the remainder beneficiaries an option to create a "reverse QPRT" for the benefit of the original grantor. In the typical fact pattern, Parent set up a qualified personal residence trust in which he or she retained the right to occupy the home for a fixed term of years. Following the end of the term, the remainder would pass to Parent's children in equal shares. The trust will terminate upon the later of Parent's death or the expiration of the trust term. Parent wants to modify the trust in a manner permitted under state law. After the modification, the new and improved trust instrument will give the children the power at the end of Parent's set term interest either to appoint an equal share of the principal to themselves or, by unanimous agreement, to give Parent another term interest in the house. In these rulings, the grantor asked for a ruling that the modified trust will not trigger § 2702, and the Service has granted this request. Importantly, all of the rulings are careful not to pass judgment on the estate tax ramifications of the reverse QPRT technique to the original grantors. So stay tuned for more developments. *Private Letter Ruling 200935004* (August 28, 2009); *201006012* (February 12, 2010) *201014044* (April 9, 2010); *201019006*, *201019007*, and *201019012* (May 14, 2010); *201024012* (June 18, 2010).

Section 2703: Certain Rights and Restrictions Disregarded

Gifts Within Six Days of Formation of Family Limited Partnership Are Eligible for Discounts, But Transfer Restrictions Disregarded. The taxpayer was an employee of Dell Computer Corp. from 1998 through 2001. He owned a substantial amount of company stock that he had acquired both by purchase and through the exercise of stock options. The taxpayer and his spouse established Uniform Transfers to Minors Act (UTMA) accounts for each of their children, and they regularly made annual contributions of stock to these accounts. In 1999, the taxpayer began some sophisticated estate planning through the advice of counsel. The taxpayer created a family trust that named his mother as trustee and listed the children as primary beneficiaries. The taxpayer funded this trust with cash and 100 shares of Dell stock. The taxpayer, his spouse, and the trust then formed a family limited partnership. The trust contributed its 100 shares of Dell stock and the taxpayer and his spouse contributed another 70,000 shares in the company. Following the contributions, the taxpayer and his spouse each held a 0.89% general partner interest and a 49.04% limited partner interest while the trust held a 0.14% limited partner interest. The partnership agreement contained a number of restrictions on transfers of partnership interests. About a week later, the taxpayer and his spouse gifted a combined 84.32% in limited partner interests to the family trust and to a UTMA account for their youngest child. As a result, the trust held a 70.2% limited partner interest and the youngest child had a 14.26% limited partner interest. The custodians of the

UTMA accounts then transferred their Dell stock to the partnership in exchange for limited partner interests, further diluting the retained interests of the taxpayer and his spouse. Additional annual exclusion gifts of limited partner interests were made by the taxpayer and his spouse in each of 2000 and 2001. The taxpayer and his spouse reported total gifts of \$601,827 in limited partner interests for 1999, \$40,000 in 2000, and \$40,000 in 2001. The Service determined that the value of the gifts was \$1,184,684, \$78,912, and \$78,760, respectively. The Service argued that the 1999 gifts were indirect gifts of the Dell stock and not direct gifts of limited partner interests. The Tax Court rejected this argument, finding that the six-day delay between the funding and gift transfers meant that there was a direct gift of limited partner interests. The Service asserted that the funding and gift transfers should be collapsed under the step transaction doctrine, but the court held that the six-day delay was meaningful in that the taxpayer and his spouse had a genuine economic risk of a change in the net asset value of the partnership during that time. So far, so good for the taxpayer. As to the annual exclusion gifts, the Service argued that their values should ignore the transfer restrictions contained in the partnership agreement, citing § 2703(a)(2). On this point, the Service prevailed. As the court explained, § 2703(b) says that a transfer restriction may only be taken into account for valuation purposes if: (1) the restriction is a bona fide business arrangement; (2) the restriction is not a device to make gifts to family members; and (3) the terms of the restriction are comparable to arrangements that would be entered into as part of an arm's-length transaction. The court held that there was no business purpose for the transfer restrictions in the partnership agreement because the entity did little other than hold Dell stock. The court relied on the fact that the stated purpose of the trust was to manage family assets and to protect them from being mismanaged by the children. The court further held that the transfer restrictions were a device for making gifts to members of the taxpayer's family. According to the court, the purpose of the transfer restrictions was to discourage the children from dissipating wealth. How do transfer restrictions in a partnership agreement do this, you ask? Well, the court says they do so by not letting a child realize the difference between the liquidation value of his or her limited partner interest and the fair market value of that interest. Plus, if the partnership exercises its right to repurchase an interest that has been improperly assigned at its (discounted) fair market value, it would pay an amount less than the proportionate net asset value of the partnership. This, in turn, would increase the value of the interests of remaining partners, who include natural objects of the taxpayer's bounty. (How many times did you reread those last few sentences before the court's logic made sense?) So since § 2703 applies to the transfer restrictions, they should be ignored in valuing the limited partner interests gifted. That brought the court to the valuation of the limited partner interests. The taxpayer argued for minority interest discounts ranging from 10 – 16.3%, while the Service's expert suggested the proper ranges were 5 – 13.4%. The court ended up applying minority interest discounts in the range of 4.63 – 14.34%. As for the marketability discount, the taxpayer's expert made the case for a 35% rate and the Service's expert said the appropriate rate was 12.5%. The court sided with the Service, embracing the expert's approach that compared private placement discounts from the time when there was a two-year holding period under Rule 144 for restricted stock (and before institutional investors could buy and sell restricted stock) with the discounts from the time when institutional investors were allowed to buy and sell restricted stock but before the holding period was reduced to one year). The court agreed that the difference between these discounts "would appear to reflect the discount investors required for having virtually no secondary market." The taxpayers appealed the § 2703 and valuation issues to the Eighth Circuit, but that court affirmed the Tax Court's decision. The taxpayers alleged that the Tax Court's decision improperly imposed an operating business requirement in to § 2703(b). They claimed the "bona fide business arrangement" prong should be applied by looking only at a taxpayer's stated intentions and not the actual context or underlying assets. But the appellate court concluded that the Tax Court properly assessed the personal and testamentary nature of the partnership's transfer restrictions. The court agreed that the transfer restrictions were mainly intended for estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education of the children. In reaching this decision, the court noted several facts that were not helpful to the taxpayers. First, the partnership was not engaged in any business activity at all. Second, it held only a small fraction of the stock in a highly liquid and easily

valued company. Finally, the taxpayers expressed no intentions as to the partnership's investment strategies, including whether the partnership would hold or sell the stock. *Holman v. Commissioner* (8th Cir., April 7, 2010).

Section 3111: Rate of Tax

Elementary, My Dear Watson—Sometimes Dividends Are Wages. In 1992, the taxpayer helped form an accounting firm. In 1996, all of the firm's partners, including the taxpayer, formed their own S corporations to which they contributed their ownership interests in the firm. Then the partners, their S corporations, and the firm entered into employment agreements whereby the partners became employees of their corporations and agreed to provide accounting services exclusively to the firm. During 2002 and 2003 (the taxable years at issue), the taxpayer operated provided accounting services exclusively to the firm as an employee of his corporation. The firm provided professional liability insurance for the taxpayer and had the authority to determine how much vacation he could take. The firm's website listed the taxpayer (not his corporation) as a partner. At shareholder meetings the taxpayer held with himself during the years at issue, he authorized for himself a salary from the corporation in the amount of \$24,000 annually. In selecting his salary, the taxpayer simply consulted with the other partners as to the amount of salary each would pay himself. In 2002 and 2003, the corporation paid the \$24,000 in salary and paid federal employment taxes on that amount. In addition to the salary, the taxpayer received \$203,651 from his corporation in 2002, \$118,159 of which was recorded as dividends. In 2003, the taxpayer received \$221,577 in dividend payments on top of his salary. In both years, the taxpayer worked for his corporation about 40 hours per week for about 46 weeks per year. His monthly living expenses in both years exceeded his \$2,000 monthly salary. The Service assessed \$48,519 in taxes, penalties, and interest against the corporation for 2002 and 2003 after determining that portions of the dividend distributions should be recharacterized as wages subject to employment taxes. The taxpayer argued that the corporation's intent controls the issue of whether funds paid to a shareholder-employee are wages or dividends, but the court found plenty of authorities indicating that the corporation's subjective intent is hardly controlling. In many cases, the Service and the courts have recharacterized putative dividends as wages where it appears that the wages paid are far below a reasonable compensation for the services performed. Thus the corporation's self-proclaimed intent to pay the taxpayer \$24,000 in salary does not limit the Service's ability to recharacterize dividends as wages, even though the corporation took all steps to properly document its claimed intent in the corporate records. Accordingly, the court refused the taxpayer's request for summary judgment. *Watson v. United States* (S.D. Iowa, May 27, 2010).

Section 3121: Definitions

Fisherman Again On the Hook for Self-Employment Tax. Throughout the taxable years at issue, the taxpayer worked as a crew member on a fishing boat. The boat always had a crew of five or fewer individuals. His compensation was determined as a percentage of the proceeds from the sale of the boat's catch. The taxpayer made or supervised various repairs to the boat, for which he was compensated separately. The boat owner reported the taxpayer's total compensation (from the fishing and the repair work) on Forms 1099-MISC, and the taxpayer included these amounts in gross income on his returns for the years at issue. But the returns did not report any self-employment tax, and that was the bait that attracted the Service's attention. Section 3121(b)(20) provides that crew members of a fishing boat with less than ten crew members are self-employed individuals where their compensation is set as a share of the boat's catch or the proceeds from the sale of a catch. A prior case involving the same taxpayer (!) held that a crew member is self-employed under this definition even where certain expenses are subtracted from the proceeds of a catch before the crew member's share is computed. Since this case involves the same facts, just different taxable years, the court was comfortable in reaching the same

conclusion. The taxpayer argued that the result here should be different because he was also paid for repair work, but the court held that the taxpayer's "activities repairing and maintaining the boat between voyages were not related to his activities as a crewman. [The taxpayer] was engaged in two separate self-employment activities: (1) As a crewman whose remuneration was based on the size of the catch; and (2) as a mechanic providing repair services to the boat's owner." Thus, the repair work had no effect on the classification of the taxpayer's status as self-employed as regards the compensation received as a share of the catch. *Anderson v. Commissioner*, T.C. Memo. 2010-1 (January 4, 2010).

Section 6011: General Requirement of Return, Statement, or List

Proposed Regulations Would Subject Certain Generation-Skipping Transfers to Disclosure Requirements and Potential Penalties. Taxpayers that promote or participate in transactions that are the same or substantially similar to transactions identified by the Service as tax avoidance transactions or "listed transactions" are subject to disclosure rules and potential penalty rules. Treasury has now proposed that transactions involving the generation-skipping transfer tax will also be subject to these rules. As to whether Treasury has specific GST-tax transactions in mind, the preamble to the proposed regulations indicates that "the IRS and Treasury Department do not have plans to identify any such transaction at this time." The proposed regulations would also modify and clarify some of the rules relating to the disclosure obligations of material advisors. Proposed Regulation § 26.6011-4 (September 11, 2009).

Section 6015: Relief From Joint and Several Liability on Joint Return

Spouse's Lack of Participation in Prior Proceeding Precluded Application of Res Judicata. In 2004, Joseph and Sari had three consolidated cases before the Tax Court for tax years 1996, 1997, and 1998. The cases involved the substantiation of business expenses claimed by the Joseph. Their attorney raised the issue of innocent spouse relief for Sari in the petition for 1996 but not in the petitions for 1997 or 1998. In the stipulation of facts for the consolidated cases, Sari withdrew her claim for innocent spouse relief. Joseph died after the opinion in the consolidated cases was filed but before final decisions were entered. Once the decisions were entered, Sari filed an administrative claim for innocent spouse relief for all three years. The Service determined that she did not qualify for relief under § 6015 and that her claim was barred by res judicata under § 6015(g)(2). That provision states that "if a decision of a court in any prior proceeding for the same taxable year has become final, such decision shall be conclusive except with respect to the qualification of the individual for [innocent spouse] relief which was not an issue in such proceeding. The exception contained in the preceding sentence shall not apply if the court determines that the individual participated meaningfully in such prior proceeding." The Tax Court held that § 6015(g)(2) did not apply and that Sari could still request innocent spouse relief. As to whether Sari participated meaningfully in the consolidated cases, the court observed that Sari, who was not an attorney and did not have a high school education, did not sign any court documents in the consolidated cases, did not review the petitions or the stipulations of facts, and did not agree to any of the stipulations. The couple's attorney, hired by Jonathan, did not discuss the documents with Sari, who only saw them for the first time at the trial in this present case. Sari did not meet with any Service personnel, did not participate in any settlement negotiations with the Service, and did not attend any such meetings between her attorney and the Service during the litigation of the consolidated cases. Because "she was more like a third-party fact witness than a participating litigant[, the] totality of the evidence demonstrates that petitioner was never fully informed or engaged in the litigation." As for whether innocent spouse relief was an issue in the consolidated cases, the court noted that innocent spouse relief was raised only in the pleadings for 1996, so Sari could still ask for relief for 1997 and 1998. Coming back to the 1996 petition, the court observed that it did not specify the requested basis for innocent spouse relief (i.e., complete

relief under § 6015(b), apportioned relief under § 6015(c), or equitable relief under § 6015(f)). The court effectively treated the generic request for relief as a request under § 6015(f)). The court effectively treated the generic request for relief as a request under § 6015(b), meaning she should still make a claim for relief under § 6015(c) or § 6015(f). *Deihl v. Commissioner*, 134 T.C. No. 7 (February 23, 2010).

Spouse's Actual Knowledge and Refusal to Cooperate Weigh Against Relief. Dorianne and Edward were married throughout the taxable years at issue but are now divorced. Edward operated a construction business during the years 1993, 1994, and 1995. Their 1993 joint return was prepared by a tax professional, but all other returns during the years at issue were prepared by Dorianne. She had some knowledge of accounting and worked as a bookkeeper. When the Service audited their 1993, 1994, and 1995 joint returns, it requested substantiation for the claimed business expenses on the Schedule C. Dorianne and Edward refused to provide the substantiation and together decided not to cooperate with the audit. Not surprisingly, the Service issued deficiency notices for 1993, 1994, and 1995, but the couple did not petition the Tax Court. The deficiencies and the resulting additions to tax were assessed in 1998. Following her divorce in 2006, Dorianne sought relief from both the deficiencies for 1993, 1994, and 1995, and the unpaid assessments of tax reported on all the returns at issue. Now the divorce decree specified that any liabilities on all joint returns filed for all years through 2002 would be paid equally by the couple. It also provided that if an audit occurred, Dorianne and Edward would share equally in the receipt of any resulting tax refund or in the payment of any taxes, penalties or interest. Dorianne failed to pay her outstanding tax liabilities so the Service sought to levy. She and Edward filed for an offer-in-compromise for their 1993, 1994, 1995, 1997, 1999 and 2000 tax years, but they were rejected. So Dorianne then asked for equitable relief with respect to her joint liabilities for the 1987 through 2002 tax years. When the Service turned her down, she went to Tax Court. The Tax Court, however, held that she was not entitled to innocent spouse relief as she had actual knowledge of the items giving rise to the deficiencies. Although there were factors in support of her claim for relief (economic hardship and lack of significant benefit), other factors weighed against relief (knowledge or reason to know of the facts giving rise to the deficiency and lack of good-faith effort to comply with tax laws in subsequent years). The court observed that actual knowledge of the item giving rise to the deficiency (as opposed to just reason to know) weighed heavily against relief. Here, Dorianne knew of the unsubstantiated expenses as she prepared the returns, and her subsequent noncompliance with the tax laws was simply too egregious to ignore. *DeMattos v. Commissioner*, T.C. Memo. 2010-110 (May 18, 2010).

Regulation Limiting Timeframe for Requests for Equitable Relief Valid After All. Dick (a dentist) and Cathy filed a joint return for 1999. In 2002, after learning that Dick was arrested and convicted for Medicare fraud, the Service determined that the income was understated on the 1999 return. It assessed over \$900,000 in taxes, interest, and penalties. In 2003, the Service sent a letter to Dick and Cathy proposing to levy against their assets. Dick assured Cathy he would handle correspondence with the Service, even though he was in jail. To his credit, Dick did so. When the Service applied her income tax overpayment from 2005 against the 1999 joint liability, Cathy filed for innocent spouse relief. Her request was filed on June 23, 2006. The Service denied her request without considering the merits, because it determined that Cathy's request came more than two years after the Service commenced its collection action in 2003, and Regulation § 1.6015-5(b)(1) limits the time for requesting innocent spouse relief to two years. Upon receipt of this determination, Cathy went to Tax Court. She argued that the two-year limitation should not apply to requests for equitable relief. The Tax Court held (12-5) that while the regulation was entitled to *Chevron* deference, it nonetheless represented an impermissible interpretation of the statute. The Service argued that the regulation was valid because § 6015(f) itself was silent as to the intent of Congress. But the court held that "by explicitly creating a 2-year limitation in subsections (b) and (c) but not subsection (f), Congress has 'spoken' by its audible silence. Because the regulation imposes a limitation that Congress expressly incorporated into subsections (b) and (c) but omitted from subsection (f), it fails the first prong of *Chevron*." Moreover, the court observed, equitable relief under the statute is to be considered when the taxpayer is ineligible for relief under § 6015(b) and

(c). “In order for (equitable) relief to be more broadly available than under the 2-year filing rule of subsections (b)(1)(E) and (c)(3)(B), a deadline under subsection (f) would need to be longer than 2 years.” While the other avenues for relief were intended to apply in specific situations, equitable relief is meant to be a general remedy, so importing a deadline from the specific remedies thwarts Congress’s intent. The court noted that regulations under § 66 do not impose timing requirements on requests for equitable relief because (and this is the language from the regulation) “the legislative history of the equitable relief provision does not contain similar timing requirements.” The court determined that Treasury needs to be consistent and apply a similar rule for equitable relief requests under § 6015. Having held the regulation invalid in the context of equitable relief cases, the court ordered the Service to consider the merits of Cathy’s case. The dissenters believed that the regulation met *Chevron* test. To them, it makes sense that the statute imposes a two-year limit in § 6015(b) and (c) while being silent in § 6015(f), for equitable relief is discretionary while the other avenues for relief must be granted if the taxpayer meets the applicable requirements. As a discretionary avenue for relief, Treasury can impose reasonable limits on the timeframe for requests. Judges Thornton and Holmes believe “the Secretary acted eminently reasonably in exercising his procedure-making authority by prescribing a deadline under subsection (f) that is comparable to the statutory deadlines under subsections (b) and (c) and identical to the regulatory deadline for equitable relief under § 66(c). Indeed, considerations of administrability strongly support consistent deadlines under these various provisions. Spouses filing requests for relief under either § 6015 or § 66(c) use the same Form 8857, Request for Innocent Spouse Relief. Many if not most spouses requesting relief may be unsophisticated in the tax laws and may not fully appreciate which of the various provisions of § 6015 or § 66(c) might be most likely to benefit them. We doubt that most applicants seeking relief carefully parse the different categories for which they might qualify; more likely, they simply plead for whatever relief might be available. In recognition of this reality, the Secretary’s Form 8857 elicits information pertinent to all forms of relief under §§ 6015 and 66(c) but does not require the requesting spouse to specify under which section or subsection relief is sought. Similarly, the regulations provide that a single claim for relief will suffice for considering relief under § 6015 (b), (c), and (f). Having comparable deadlines for the various types of relief facilitates this sensible administrative practice. The majority would confound this practice in bizarre ways and place undue pressure upon the manner in which the request for relief might be drawn up or characterized.” On appeal, the Seventh Circuit reversed, upholding the validity of the Service’s two-year statute of limitations. As Judge Posner observed, “Agencies, in contrast, being legislative as well as adjudicatory bodies, are not bashful about making up their own deadlines. And because they are not bashful, and because it is as likely that Congress knows this as that it knows that courts like to borrow a statute of limitations when Congress doesn’t specify one, the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision. Whether the Treasury borrowed the two-year limitations period from subsections (b) and (c) or simply decided that two years was the right deadline is thus of no consequence; either way it was doing nothing unusual. ... In short, if there is no deadline in subsection (f), the two-year deadlines in subsections (b) and (c) will be set largely at naught because the substantive criteria of those sections are virtually the same as those of (f).” About two weeks after the Seventh Circuit issued its opinion, the Chief Counsel instructed the Service’s attorneys to continue arguing that the two-year deadline is valid in all currently docketed cases and not to settle or concede the issue in any docketed case. *Lantz v. Commissioner* (7th Cir., June 8, 2010).

Section 6081: Extension of Time for Filing Returns

Estate Had Good Reason for Not Filing Timely Extension Request. The decedent’s estate consisted mostly of illiquid assets, and a single life insurance policy represented over 60% of the estate’s potential liquid assets. The estate received the death benefit from the policy at the same time the estate tax return was due. The estate filed neither a return nor an automatic extension request by the original

deadline. Forty days later, however, the estate submitted a completed extension request and paid \$1.8 million in estimated estate taxes. In explaining the request for an extension, the estate claimed that amount of the marital deduction “has been very difficult to determine accurately and has created significant delays in assessing the overall taxable estate.” The estate also claimed it did not receive all appraisals in time to complete the return by the original due date. Finally, as regards payment of the estimated estate tax, the explanation asserted that “[t]he primary source of funds to pay the estate tax is an insurance policy payable to the estate. The proceeds from this policy were only recently received. The balance of the funds was contributed by the beneficiaries of the estate, who were required to liquidate personal assets to make up the shortfall. Prior to this time, payment of the estate tax liability would have been impracticable.” The Service denied the request for extension, presumably because it was filed late, though no formal explanation of the grounds for denial was ever given. The Service assessed interest and both a late filing and late payment penalty against the estate. The estate paid these amounts and sued for refund. The district court granted the estate’s motion for summary judgment, agreeing that the Service abused its discretion in denying the request to extend the time for filing the estate tax return even though the estate demonstrated good and sufficient cause for an extension. The court concluded that there was no indication of bad faith on the part of the estate and no showing of how the Service’s interests would be prejudiced by granting the extension. As for whether there was good cause for filing a late extension request, the court observed that tensions among the beneficiaries made it hard for the estate to obtain the information needed to file a reasonably accurate return and extension request by the due date. Had the estate been forced to provide an extension request on time, the estimated estate tax liability would have been “totally unreliable” because of the wide range of possible marital deductions. So the estate wins on all counts. *Estate of Proske v. Commissioner* (D.N.J., May 25, 2010).

Section 6110: Public Inspection of Written Determinations

Tax Court Can’t Prevent Publication of Private Letter Ruling. On October 1, 2004, the taxpayer submitted a request for a private letter ruling. On September 17, 2007, the Service informed the taxpayer that it intended to issue an adverse ruling. The Service told the petitioner that the request for the ruling could be withdrawn, but the taxpayer declined to do so. On October 5, 2007, the adverse ruling was issued. On December 6, 2007, the taxpayer petitioned the Tax Court to restrain public disclosure of the ruling and to order the Service not to share the ruling among its employees. According to the taxpayer, the Tax Court has this power under the Administrative Procedure Act, but the court disagreed. The statute “limits this Court’s determination to the Commissioner’s deletion decisions. That section does not give this Court the authority to order the Commissioner to restrain disclosure of a PLR in its entirety. The Tax Court is a Court of limited jurisdiction, and we may exercise our jurisdiction only to the extent provided by Congress. This Court’s jurisdiction ... is explicitly limited to making a determination with respect to the Commissioner’s decision not to delete information from a written determination or background file document which is to be open to public inspection.” While the court refused to order the withholding of the entire ruling, it denied the government’s summary judgment motion as to whether certain terms in the ruling will identify the taxpayer, so one can expect more developments in this case. *Anonymous v. Commissioner*, 134 T.C. No. 2 (January 19, 2010).

Section 6166: Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business

Timing is Everything, Especially When It Comes to the § 6166 Election. Following the decedent’s death in Year 1, the personal representative of the decedent’s estate hired an attorney and an accountant to handle the probate and the preparation and filing of the Form 706. Using valuations provided by the attorney, the accountant recommended that the estate take advantage of the special use

valuation election under § 2032A, the installment payment of estate taxes election under § 6166, and the then-applicable qualified family-owned business interest deduction under § 2057. The accountant then filed an extension for the estate tax return, which the Service granted. Before the extended due date for the Form 706, the accountant told the attorney that a second extension would be filed, but apparently it never was. Over the course of Years 2 through 6, the accountant prepared Forms 1041 for the estate and assured the personal representative that there were no pending deadlines related to the Form 706. It wasn't until Year 7, when the attorney asked for copies of the elections and extensions filed by the accountant, that the personal representative learned that no additional extensions were requested and the Form 706 was never filed. So the estate came to the Service, hat in hand, seeking to make the elections under §§ 2032A, 2057, and 6166. The Service ruled that the estate could still make a special use valuation election and claim a qualified family-owned business interest deduction, but ruled that the estate may not make the election to pay estate taxes in installments. The §§ 2032A and 2057 elections are still available because the regulations permit the elections even where the estate tax return is not timely filed—all that is required is that these elections be made on the first return filed. But the §6166 election is unavailable because §6166(d) requires an estate to make the election by the estate tax return's due date. Here, because no additional extensions were obtained, the estate tax return is coming several years after it was due. The Service said it had no ability to play with this deadline because the deadline for making the §6166 election is prescribed by statute. "The mere fact that regulations under § 6166 parrot the deadline set forth in the statute itself does not transform the election from a statutory election into a regulatory election." *Private Letter Ruling 201015003* (April 16, 2010).

Section 6501: Limitations on Assessment and Collection

Six-Year Limitation Period Applies When Foreign Currency Gains and Losses Not Separately Reported. A group of LLCs, all partners in the taxpayer, entered into foreign exchange digital option transactions (FXDOTs) pursuant to which they purchased 30-day European-style digital options based on the exchange rate between the United States Dollar and the Japanese Yen. Each FXDOT had a long leg and a short leg. In the long leg, an LLC paid an initial sum for the right to receive a predetermined, fixed amount if the exchange rate was at least ¥107.27 on the termination date. In the short leg, the LLC received an initial sum in exchange for agreeing to pay a specified, fixed amount if the exchange rate was at least ¥107.29 on the termination date. The combined premium on the long leg of the FXDOTs was \$8,400,000, and the combined premium on the short component of the FXDOTs was \$8,316,000. The LLCs combined paid only the \$84,000 difference between these amounts. In November, 1999, the LLCs contributed these options, some cash and some shares of two other corporations to the partnership. In determining their outside bases in the partnership, the LLCs included the long option premiums but made no reduction for the short option premiums received. The FXDOTs expired late in 1999, unexercised while held by the partnership. The partnership reported a loss of \$84,000 realized upon the expiration of the FXDOTs as "Other income (loss)" on its return for 1999. This net loss represented an \$8,400,000 loss from the long option less the \$8,316,000 gain from the lapse of the short option. The partnership attached a statement to its return, describing the \$84,000 loss as a § 988 foreign currency loss. Importantly, the partnership did not disclose that the net loss resulted from the expiration of the long and short options and did not separately report the \$8,400,000 loss from the long options and the \$8,316,000 gain from the short options. When the Service assessed a deficiency in 2006, the partnership responded that the statute of limitations had passed. The Service claimed that the six-year statute of limitations applied because there was a substantial omission from gross income due to the partnership failing to separately report the gain and the loss from the options as required by § 988. Before the Tax Court, the partnership argued that it was sufficient that it reported the net loss from the long and short options. The partnership contends there would have been an omission from gross income if it had only reported the \$8,400,000 gross loss and not the \$84,000 net loss. The Tax Court held that the Service was right. "The fact that [the partnership] accurately calculated the amount of the net loss arising from the offsetting options does not

preclude the application of the 6-year limitations period if [the taxpayer] or the partners were required to compute and report any gain from the short options separately from any loss from the long options,” noted the court. And yes, they were so required—regulations under § 988 clearly provide that a taxpayer must “separately compute and report the amount of foreign currency gain or loss realized on each § 988 transaction.” By failing to report the gains from the lapse of the short legs, said the court, the taxpayer had a substantial omission from gross income sufficient to trigger the six-year statute of limitations. *Highwood Partners v. Commissioner*, 133 T.C. No. 1 (August 13, 2009).

Statute Does Not Start to Run When You File a Return With All Zeroes. The taxpayer did not file returns for 1996, 1997, or 1998 until 2000, but the returns filed in 2000 listed zero on every line. The Service refused to treat these returns as filed and created its own substitute returns instead. The substitute returns reflected sales from eight separate real estate transactions. In 2003, the Service made numerous attempts to communicate with the taxpayer to work out the tax delinquencies, but the taxpayer did not cooperate. Instead, the taxpayer sent the Service pages of tax protestor arguments. The taxpayer also refused to provide the Service with any basis or expense information that could lower his taxable income and, thus, the interest and penalties. The taxpayer eventually filed for bankruptcy, and the Service filed a tax claim. The taxpayer objected to the claim. During discovery, the taxpayer at last furnished documentation of his cost basis and expenses for the real estate transactions. The Service accepted this information and recalculated the tax assessment, but at the same time it also included in gross income the gains from four other real estate transactions not included in the original assessment. The taxpayer had the chutzpah to argue that he was not liable for the additional taxes from the four new transactions because the statute of limitations had expired for assessing any new taxes for the years in question. The bankruptcy court appropriately rejected this position, noting that the statute of limitations never began to run when the taxpayer filed returns listing zero on all line items. Consistent with precedent from the Tax Court, the court held that a return is not considered “filed” unless: (1) there is sufficient data to calculate tax liability; (2) it purports to be a return; (3) there is an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) the taxpayer executes it under penalties of perjury. The court found that none of the first three requirements were met, so the Service was not precluded from adding in the newly-discovered gains. *In re McKay* (Bankr. M.D. Fla., June 22, 2010).

Section 6662: Imposition of Accuracy-Related Penalty on Underpayments

Strike One: Claiming the Loss. Strike Two: Blaming TurboTax. Strike Three: Citing Wikipedia. The taxpayer operates a real estate business. She prepared her 2004 and 2005 joint returns using TurboTax. In examining the return, the Service disallowed claimed rental losses because the subject property was held for personal purposes (it was rented free of charge to the taxpayer’s uncle) and it converted claimed trading losses from ordinary losses to capital losses. When the Service assessed deficiencies and an accuracy-related penalty in connection with these adjustments, the taxpayer conceded liability for the deficiency but petitioned the Tax Court for relief from the accuracy-related penalty. The taxpayer argued that there was reasonable cause for the mistreatment of the items giving rise to the deficiency because she relied on Turbo Tax to get it right. The Tax Court did not buy it (the argument, not TurboTax). “We do not accept petitioners’ misuse of TurboTax, even if unintentional or accidental, as a defense to the penalties on the basis of the facts presented. At trial [the taxpayer] did not attempt to show a reasonable cause for [the] underpayment of taxes. Instead, she analogized her situation to that of the Secretary of the Treasury, Timothy Geithner. Citing a Wikipedia article, [the taxpayer] essentially argues that, like Secretary Geithner, she used TurboTax, resulting in mistakes on her taxes. In short, it was not a flaw in the TurboTax software which caused petitioners’ tax deficiencies. ‘Tax preparation software is only as good as the information one inputs into it.’” *Lam v. Commissioner*, T.C. Memo. 2010-82 (April 19, 2010).

Section 7701: Definitions

2010 Health Care Act: The Economic Substance Doctrine is Now Codified, So Violations Can Trigger Penalties. The § 6662 accuracy-related penalty now applies to any disallowed tax benefits because a transaction lacks “economic substance” or fails any similar rule of law. (And the penalty increases from 20% of the understatement to 40% of the understatement if the transaction lacking economic substance is undisclosed.) A new definitional provision provides that a transaction has economic substance where: (1) “the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position;” and (2) “the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.” The new penalty and the definition of economic substance apply to transactions entered into on or after March 30, 2010. *Section 7701(o)*.