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CHAIR'S MESSAGE

As we bring close to another year for the Tax Section, it is time to reflect back over the activities and accomplishments of the Section for 2012-2013. Before summarizing our activities this past year, I want to specifically thank the Officers, Council Members, Committee Chairs and Vice Chairs, and all of you for your hard work this year. Elizabeth Copeland, Chair-Elect, is ready to step in and continue moving the Section forward. The involvement and dedication of so many members to improve our Section and the tax laws, both statewide and nationally, is truly inspiring. I have never been more excited about the future of our Section.

Annual Meeting

Part of this excitement is because of the outstanding line-up we have for this year's Annual CLE Program. The Tax Section's 2013 Annual Member Meeting and CLE Program will be held as part of the State Bar of Texas Annual Meeting which runs from June 20-21, 2013, and will be held at the Hilton Anatole, in Dallas. Our Annual Meeting will be held on Friday, June 21, 2013, at 8:00 a.m. followed by the CLE Program which will begin at 8:30 a.m. This year's world-class program is headlined by Douglas Shulman, Former Commissioner of the Internal Revenue Service, Kathryn Keneally, Mark Matthews, Terrance Cuff, and our own Professors Stanley Johanson and Christopher Hanna. The topics and presenters are:

- State of the Tax System and Tax Reform: Views of the Internal Review Service From the Inside and Out: Douglas Shulman, Former Commissioner, Internal Revenue Service
- Current Initiatives of the Department of Justice Tax Division: Panelists, Jasper Taylor and Kathryn Keneally, Assistant Attorney General Department of Justice Tax Division
- The World is Getting Smaller – Foreign Account Tax Compliance Act and Internal Revenue Service Tax Compliance Initiatives: Mark Matthews
- Lunch with Tax Legend – Professor Stanley Johanson: Moderator, William D. Elliot
- Partnership Target Allocations and Partnership Drafting Issues: Terence Cuff
- Estate Planning Update: Professor Stanley Johanson
- Adventures in Tax Reform: Professor Christopher Hanna

This year's Annual Meeting CLE Program is made possible by the generosity of our sponsors. THANK YOU, SPONSORS!!!

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Thompson & Knight, LLP.

It is not too late for you or your firm to become a sponsor of the Annual Meeting CLE Program and the Leadership Academy. Please contact me at (903) 223-9544 or tgreen@capshawgreen.com if you are interested in being a sponsor.

Thanks to Matthew Larsen, Elizabeth Copeland, and Michael Threet for their hard work in putting together such an outstanding Annual Meeting CLE Program and coordinating all of the details. I highly recommend attending the 2013 Annual Member Meeting and CLE Program this year. Register now! As a reminder, to receive CLE credit for attending the Tax Section 2013 Annual Meeting CLE Program, you will need to register for the State Bar of Texas Annual Meeting at: http://www.texasbar.com/AM/template.cfm?section+annual_meeting&template=/CM/htmldisplay.cfm&contentid=12733.

Leadership Academy

The Section's Leadership Academy graduated its inaugural class of 19 participants on January 17, 2013. The Leadership Academy allows young tax lawyers to develop their leadership skills and network with other tax lawyers throughout the state. This program would not have been possible without the hard work of David Colmenero who spearheaded the Leadership Academy as its Program Director. Many thanks to David and his committee members: Ryan Gardner, Christina (Christi) A. Mondrik, and Alyson Outenreath. We also want to thank the firms of Strasburger Price Oppenheimer Blend in San Antonio, Fulbright & Jaworski, LLP, in Houston, and Jackson Walker, LLP, in Austin, for hosting a meeting in their respective cities for our Academy participants. In addition, a special "thank you" to Susan House of Meadows Collier for her efforts in handling the logistics and various other issues that arise with a program of this nature.

This program will be held every other year so be on the lookout for application forms toward the end of 2013 for the next class of the Leadership Academy. In the meantime, if you have any questions, please contact David Colmenero at (214) 744-3700 or dcolmenero@meadowscollier.com.

COGS Projects

The Section continues its tradition of improving the substance and administration of State and Federal tax laws through its Committee on Government Submissions ("COGS") process. The COGS process is one of the means by which the Section is working to enhance the Section profile as well as that of its members within the tax community and furthers the national reputation of the Texas Tax Section. Stephanie Schroepfer served as the Chair of our COGS committee and has done an outstanding job in this capacity not only this year, but for the last few years. She was assisted by Catherine C. Scheid and David D'Alessandro as her Vice Chairs. Under Stephanie's leadership, we submitted five COGS projects to the Internal Revenue Service and three to the Texas Comptroller of Public Accounts. The projects submitted to the IRS and the

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Department of Treasury included comments relating to (1) proposed section 83 regulations dealing with compensatory transfers of property, (2) comment relating to proposed Treasury regulations regarding wellness programs, (3) comment on Section 4980H pay or play group health plan proposed regulations, (4) comment concerning Circular 230, and (5) comments on the proposed 3.8% Medicare Tax. The projects submitted to the Texas Comptroller included comments relating to (1) proposed new process for issuing private letter rulings and the Taxpayer Bill of Rights, (2) proposed procedures concerning refunds and payments under protest, and (3) proposed rules on cost of goods sold.

In addition, there are pending written comments of (1) the Corporate and Partnership and Real Estate Tax Committees relating to proposed section 1411 regulations, (2) the Estate and Gift Tax Committee relating to proposed 706 GSD Form, (3) the Employee Benefits Committee relating to the application of financial products tax reform to equity compensatory grants, (4) Energy and Natural Resources and Tax Controversy Committees relating to material advisor proposed penalty regulations, and (5) the Partnership and Real Estate Tax Committee relating to carried interests.

The Employee Benefits Committee members, Henry Talavera and Stephanie Schroepfer, and the Estate and Gift Tax Committee members, Lora Davis and Melissa Willms, also presented oral testimony in hearings with the Department of Treasury involving proposed revisions to section 414(d) governmental plan rules and section 1411 proposed Treasury regulations respectively.

Many thanks to the State and Local Tax Committee and Ira A. Lipstet, Sam Megally, Charlotte Noel, Matt Hunsaker and Alyson Outenreath; the Corporate Tax Committee and Jeffry Blair; the Employee Benefits Committee and Susan Wetzel, Henry Talavera, Heather C. Panick, David D'Alessandro, Josephine Stewart Harvey, Mark Bodron, Courtney Vomund, and Kirsten Garcia; the Tax Controversy Committee and David Colmenero, David Garr and Mary McNulty; the Energy and National Resources Committee and Shawn O'Brien; the Partnership and Real Estate Committee and Daniel Baucum, Jack Howell, Steve Phillips, Tara Avermann Potts and Bryan Jepson; and the Estate and Gift Tax Committee and Melissa Willms, Amanda Gyeszly, Lora Davis, Celeste Lawton and Tina Gardner.

2013 Outstanding Texas Tax Lawyer Award

Congratulations to Professor Emeritus Ira B. Shepard for being selected as our Outstanding Texas Tax Lawyer for 2013. Please join us in Dallas at the Annual Meeting CLE Program on June 21, 2013, to congratulate Professor Shepard as the Outstanding Texas Tax Lawyer!

24/7 Free CLE Library

As a Tax Section member, you may access the Tax Section's 24/7 library of free CLE Webcast programs at any time through the Tax Section website. Thanks to the hard work of Michael Threet, CLE Chair, there are currently 47 CLE programs available on the website for your viewing. This makes it possible for Section members to meet some or all of their CLE requirements free of cost and without ever leaving the office.

Also, a big "thanks" to Bill Elliott for his vision to preserve the history of outstanding members of our Section in videotaping interviews with our Texas Tax Legends. You may now view his latest interviews with Emily Parker and Professor Stanley Johanson which are posted on the Section website. If you have any questions about the 24/7 library or viewing the interview of our Texas Tax Legends, please contact Michael Threet, the head of our CLE Committee, at (214) 969-2795 or mthreet@akingump.com.

The Texas Tax Lawyer

Thanks to the hard work of Rob Morris, the Tax Section publishes three issues of *The Texas Tax Lawyer* each year. *The Texas Tax Lawyer* is distributed to members electronically. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. A "Practitioner's Corner" has also been added to our website, which includes forms and other useful information from past issues of *The Texas Tax Lawyer*. Please contact Rob Morris at rmorris@fulbright.com if you would like to submit an article.

Texas Bar Journal

Check out the Year in Review, Tax Law, in the January 2013 issue of the *Texas Bar Journal*. I want to thank Christi Mondrik for her assistance in preparing the article.

The Tax Court Program

The Tax Section assists *pro se* taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Thanks to our Pro Bono Chair, Bob Probasco, and his band of volunteers for providing such a needed service. Check the calendar on the Tax Section's website for the next calendar call in your city and contact Bob Probasco at (214) 969-1503 or robert.probasco@tklaw.com to assist.

Law School Outreach

We hold luncheons each year with students at the SMU Dedman, University of Texas, University of Houston, and Texas Tech University Schools of Law. Every other year, we hold luncheons at Baylor, LSU, and South Texas Law Schools. St. Mary's University, Texas Southern and Texas Wesleyan and will be visited every third year. Thanks to Abbey Garber for serving as the program coordinator responsible for organizing and recruiting panel members for these presentations. If you wish to serve as a panelist, please contact Abbey Garber, at (972) 308-7913 or abbey.b.garber@irscounsel.treas.gov.

Law School Student Paper Competition

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Many thanks to Ron Adzgery for again running this year's paper competition. The prize money this year is $2,500.00 for first place. At the judges' discretion, second and third place winners may be selected and awarded prizes of $1,500.00 and $1,000.00. The deadline for submitting papers for the 2012-2013 competition is May 31, 2013. Please see the Tax Section's website for more details.

Tax App

If you have not downloaded the Tax App, you will want to do so. The Section worked with the Computer & Technology Section to develop a "Tax App" to access Federal and Texas state tax materials from an iPhone, iPad, or iPod Touch. The Tax App is the first of its kind and gives you fingertip access to the Internal Revenue Code, Treasury Regulations, tax treaties, AFRs, IRS guidance, cases, Texas Tax Code, Texas Administrative Code, and much more.

Nominating Committee and Tax Section Leadership for 2013 – 2014

The Tax Section's Nominating Committee for 2012-2013 – Dan Micciche as Chair and Patrick O'Daniel, Mary McNulty and me as an ex officio member -- unanimously recommended the Officers and Council members listed below. Council approved the officers, who will join incoming Chair, Elizabeth Copeland. The Council members will be voted on at the Annual Meeting on June 21.

Chair-Elect: Andrius Kontrimas

Secretary: Alyson Outenreath

Treasurer: David Colmenero

Incoming Members of the Council:

Melissa Willms

Henry Talavera

Ira Lipstet

If elected, the incoming members of the Council will join Matt Larson, Catherine Scheid, and Bob Probasco, whose terms end in 2014, and Jeff Blair, Lisa Rossmiller and Susan Wetzel, whose terms end in 2015. Many thanks to Ron Adzgery, Christi Mondrik, and Ryan Gardner, for their service as Council members as their terms are now ending.

Do Yourself a Favor – Get Involved!

If you are not already involved in the Section's activities, please get involved. Contact one of the chairs of the above activities or join a committee. We have included the

Committee Selection form in this issue of *The Texas Tax Lawyer* and have also posted it on the Tax Section's website. Mark one or more Committees that you would like to join and send the form to the Committee Chair listed on the form.

When you join a Committee, you become a member of that Committee's list serv. The list serv provides you with an email forum for sharing tips, concerns, referrals and other matters with your fellow Texas tax lawyers. If you wish to opt out of the list serv, please contact Brent Gardner at (214) 999-4585 or bgardner@gardere.com.

If you are not sure who to contact and what would be the best fit for you skills, then email me at tgreen@capshawgreen.com. You will help us build an even stronger Tax Section and have some fun in the process!

Thank you

Finally, thank you for the opportunity to serve as the Chair of the Tax Section this past year. It has truly been my privilege, and I thank all of you for your work in making this year one in which we can be proud of our accomplishments. Also, a special thanks to Alyson Outenreath for serving as my "editor-in-chief" for her many reviews of draft documents, emails, and various other correspondence.

Congratulations, Elizabeth -- the gavel is now yours on June 21, 2013!

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Section of Taxation
State Bar of Texas

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☐	**Tax-Exempt Organizations**	Terri Lynn Helge Texas Wesleyan School of Law Associate Professor of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817- 429-8050 thelge@law.txwes.edu

PLEASE COMPLETE THIS FORM AND FORWARD IT TO THE COMMITTEE CHAIR(S) FOR EACH COMMITTEE THAT YOU ARE INTERESTED IN JOINING.

TAX COURT FIND STARS TRANSACTION LACKS ECONOMIC SUBSTANCE

By: Robert D. Probasco and Lee S. Meyercord[1]

In *Bank of New York Mellon Corp. v. Commissioner*, the Tax Court found that a structured trust advantaged repackaged securities ("STARS") transaction entered into by BNY Mellon lacked economic substance, and disallowed foreign tax credits of $199 million as well as transactional expenses of $8 million.[2] BNY Mellon is the first test case to emerge from the IRS's attempts to disallow tax benefits to several financial institutions that participated in the STARS transaction.

The STARS transaction is one of a number of different transactions that the IRS refers to as "foreign tax credit generators." These transactions generally rely on inconsistent treatment of the same transactions under the tax law of different jurisdictions. The inconsistent treatment may relate to the classification of an entity, the distinction between debt and equity, timing of income recognition, or various other aspects.

Some foreign tax credit generators result in foreign tax credits being attributed to and used by a U.S. taxpayer who does not bear the economic burden of those taxes. In the STARS transaction, however, the U.S. taxpayer does bear the economic burden of the foreign taxes for which it claims a credit. The U.S. taxpayer also indirectly shares in the benefits the counterparty obtains in the U.K. tax system. The U.S. taxpayer's tax position properly reflects the economics of the transaction, and the U.K. tax authority agrees with the treatment of the transaction for U.K. tax purposes. Nevertheless, the IRS has challenged these transactions and disallowed the U.S. taxpayer's claimed foreign tax credits.

1. *STARS Transaction*

The STARS transaction was developed by KPMG and Barclays Bank to generate a net U.K. tax benefit. Barclays shares the tax benefit with the U.S. bank participating in the transaction, by providing below-market financing. A simplified version of the typical structure of a STARS transaction is as follows.[3]

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[1] Robert D. Probasco is a partner and Lee S. Meyercord is an associate, in the Dallas office of Thompson & Knight, LLP. Mr. Probasco specializes in IRS audits, appeals, and tax litigation. He is a Council member, Chair of the Pro Bono Committee, and Vice-Chair of the Tax Controversy Committee of the Section of Taxation of the State Bar of Texas. Ms. Meyercord's practice includes IRS audits and appeals, and federal and state tax planning.

[2] *Bank of New York Mellon Corp. v. Comm'r*, 140 T.C. No. 2 (Feb. 11, 2013).

[3] The details in this article are derived from both the *BNY Mellon* opinion and the description of the typical transaction in CCA 200826036 (Jun. 27, 2008).

a. STARS Structure

The U.S. bank forms a Delaware trust that is disregarded for U.S. income tax purposes, and funds the trust with income producing assets in return for units in the trust. Barclays also contributes cash to the trust in return for a different class of units. Under a collateral repurchase agreement, the parties agree that in five years the U.S. bank will repurchase the trust units from Barclays. A wholly owned subsidiary of the U.S. bank is appointed as trustee of the trust. The subsidiary is a disregarded entity for U.S. federal income tax purposes, but a U.K. resident for U.K. tax purposes. Pursuant to the trust agreement, Barclays is entitled to 99% of the trust income but is also required to immediately re-contribute to the trust any distributions it receives. The trust distributes Barclays share of income, after U.K. taxes, to a blocked account to ensure that the funds are immediately returned to the trust. After the U.S. bank repurchases Barclays' units in the trust, it can access all of the accumulated trust income, net of U.K. taxes. Thus, the U.S. bank bears the economic burden of the U.K. taxes paid by the trust.

b. U.K. Tax Treatment

The trust is subject to tax at a rate of 22%, which the trust pays before distributing income to Barclays. Because Barclays must re-contribute all amounts distributed, the transaction has no net economic effect before taxes for Barclays, other than its below-market return on the repurchase agreement. But the combination of the distribution and re-contribution creates a net tax benefit for Barclays.

Barclays is subject to tax, at a rate of 30%, on its net income including distributions from the trust. The distribution is grossed-up, for Barclays' share of the tax paid by the trust, and Barclays is also treated as having paid that share of the trust's taxes. Barclays can also claim a deduction for the amounts that are re-contributed to the trust. As a result, Barclays incurs a small tax obligation related to the trust's income. But that small tax obligation is less than the amount of the trust's taxes that Barclays is deemed to have paid. Barclays thus receives a net tax benefit, for transactions which have no net economic effect. For example:[4]

Trust income	$1,000
Less taxes paid by the trust (22%)	(220)
Net amount to distribute	$780
Barclays' income	
Grossed-up distribution	$1,000
Deduction for re-contribution	(780)
Net income	$220
Tax liability (30%)	$66
Less taxes deemed paid as part of gross-up	(220)
Net tax benefit	$(154)

[4] For simplicity, this example ignores the 1% of trust income allocable to the U.S. taxpayer.

The U.K. tax authority has reviewed and approved the tax treatment of the STARS transaction by Barclays and the trust. Although in effect the tax authority pays out $154 to Barclays, that is still less than the $220 it receives from the trust. To the extent that this treatment encourages more income-producing assets being invested in the U.K., it may be beneficial not only to Barclays but also to the U.K. tax system.

c. U.S. Tax Treatment

Barclays' initial contribution to the trust combined with the repurchase agreement are treated as a secured loan rather than an equity investment. Thus, the U.S. bank is treated as owning 100% of the trust. It is taxable on the trust's income, which is treated as foreign source income under the U.S.-U.K. income tax treaty because it was subject to U.K. tax. Because the trustee is legally liable for the U.K. tax, the trustee is the taxpayer under Section 901 and the U.S. bank is entitled to a credit for the foreign taxes paid. This is consistent with the substance of the transaction. In the example above, the U.S. bank must include $1,000 in its taxable income but the accumulated assets in the trust are only $780. The bank has borne the economic burden of the $220 of U.K. tax paid by the trust.

d. Sharing the Benefits

The foreign tax credits claimed by the U.S. bank are consistent with its actual direct economic burden for the U.K. taxes.[5] Barclays receives a net tax benefit, and shares some of that benefit indirectly. The terms of the repurchase agreement are equivalent to a below-market rate secured loan from Barclays to the U.S. bank.

2. Bank of New York Mellon Corp. v. Commissioner

Bank of New York Mellon Corporation v. Commissioner involved a typical STARS transaction. BNY Mellon contributed $7.68 billion of income-producing assets to a trust with a U.K. trustee, and Barclays purchased trust units for approximately $1.5 billion, which BNY Mellon agreed to buy back in five years. This arrangement, along with a zero coupon swap and security arrangement, converted Barclays' purchase of the trust units into a $1.5 billion below-market secured loan from Barclays to BNY Mellon. The trust was subject to tax in the U.K., and BNY Mellon claimed foreign tax credits for $199 million in U.K. taxes paid in 2000 and 2001. Part of the tax was on income that was accelerated for U.K. tax purposes, but not yet subject to tax in the U.S. BNY Mellon also deducted approximately $8 million in transaction costs.

The Tax Court found that the STARS transaction was an "elaborate series of pre-arranged steps designed as a subterfuge for generating, monetizing and transferring the

[5] The amount of accumulated trust income the U.S. bank eventually recovers is net of the U.K. taxes *paid by the trust* ($220 in the example above). The *net* amount received by the U.K. tax authority, though, is only $66. The U.S. bank does not directly recover any of the net tax benefit to Barclays.

value of foreign tax credits among the STARS participants."[6] The court first identified the STARS transaction as the relevant transaction to be tested for economic substance, rejecting BNY Mellon's argument that the relevant transaction is the $1.5 billion below-market loan.

The court applied the Second Circuit's articulation of the economic substance doctrine because any appeal would be heard by the Second Circuit. The Second Circuit requires a flexible analysis of both the objective economic substance of the transaction and the taxpayer's subjective business purpose for engaging in the transaction.[7] The court concluded that the STARS transaction lacked objective economic substance because the circular cash flows of the STARS structure did not increase the profitability of the contributed assets. In fact, the structure reduced profitability by adding substantial transaction costs.

Further, the court held that BNY Mellon lacked a non-tax business purpose for engaging in the STARS transaction. The court rejected BNY Mellon's argument that it used the STARS transaction to obtain low-cost financing because there was no reasonable connection between the STARS structure and the low-cost loan. According to the court, "[m]aking a routine business transaction contingent on an economically meaningless transaction, like the STARS structure, is insufficient to establish that the nexus between the two is reasonable."[8] The court's decision has been criticized by practitioners as a vague expansion of the economic substance doctrine.[9]

BNY Mellon is likely only the beginning of the STARS saga. BNY Mellon says they will appeal the court's decision to the Second Circuit.[10] On April 2, 2013, the Court of Federal Claims concluded trial on a STARS transaction involving BB&T.[11] In addition, at least five other banks participated in the STARS transaction with Barclays, and the IRS has indicated that billions in tax revenue is at stake.[12]

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[6] *Bank of New York Mellon Corp.*, 140 T.C. No. 2, slip op. at 25.

[7] *See, e.g.*, *Gilman v. Comm'r*, 933 F.2d 143, 147–48 (2d Cir. 1991), *aff'g* T.C. Memo 1989-684 (finding that the economic substance doctrine required a flexible analysis of both the business purpose and objective economic substance of a transaction).

[8] *Bank of New York Mellon Corp.*, 140 T.C. No. 2, slip op. at 40.

[9] *Practitioners Criticize Dicta Condemning Use of FTCs for Tax Avoidance*, 2013 TAX NOTES TODAY 68-1 (Apr. 9, 2013).

[10] Andrew Zajac, *BNY Mellon Barred from $199 Million of Foreign Tax Credit*, BLOOMBERG (Feb. 12, 2013).

[11] *Salem Financial v. United States*, Docket No. 1:10-cv-00192 (Ct. Fed. Cl.). Salem Financial is successor-in-interest to BB&T. Other cases include *Sovereign Bancorp, Inc. v. United States*, Docket No. 1:09-cv-11043 (D. Mass.) and *Wells Fargo & Co. v. United States*, Docket No. 09-cv-02764 (D. Minn.).

[12] Vanessa Houlder, Megan Murphy & Jeff Gerth, *Tax Wars: A Fight Worth Billions*, FINANCIAL TIMES (Sept. 25, 2011).

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Summary of New 3.8% Income Tax on Net Investment Income under Section 1411

a.k.a. the "Unearned Income Medicare Contribution"

Summary of New 3.8% Income Tax on Net Investment Income under Section 1411

I. Background and Overview of Section 1411

A. Legislative History

Section 1411 was added to the Internal Revenue Code[1] on March 30, 2010 as part of the Health Care and Education Reconciliation Act of 2010 (the "Reconciliation Act"). The Reconciliation Act modified the Patient Protection and Affordable Care Act ("the "2010 Health Care Act") that President Obama signed into law on March 23, 2010.

Section 1411 is a revenue provision of the Reconciliation Act. It was added as part of a new Chapter 2A entitled Unearned Income Medicare Contribution. Currently, Section 1411 is the only Code section in that Chapter. The name is also a bit misleading. Although the name might suggest that the funds raised by this tax are earmarked to be contributed to the Medicare Trust Fund, these funds are actually just another tax paid into the General Fund of the United States Treasury.[2]

Although Section 1411 was added to the Code in 2010, the tax did not become effective until 2013 when Section 1411 became effective for taxable years beginning after December 31, 2012.[3]

B. Overview

1. Tax. Section 1411 imposes a 3.8% income tax on the "net investment income" (or portion thereof) of individuals, estates and certain trusts to the extent that the taxpayer's adjusted gross income (as modified or defined for purposes of this tax) exceeds a set "threshold amount" for each taxable year (the "NII Tax").[4]

2. Application to Individuals.

a) For individuals, the NII Tax is imposed on the lesser of:

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1 Unless otherwise stated, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

2 *See* Staff of the Joint Committee on Tax'n, *General Explanation of Tax Legislation Enacted in the 111th Congress* (JCS-2-11) (March 24, 2011); Preamble to Notice of proposed rulemaking and notice of public hearing, REG-130507-11, 77 Fed. Reg. 72611, 72613.

3 2010 Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

4 §1411(a).

(1) the net investment income for the individual for that taxable year, or

(2) the excess (if any) of:

(a) the modified adjusted gross income for the individual for that taxable year; over

(b) the threshold amount.[5]

Effectively, this results in the NII Tax being imposed on either all of the individual's net investment income or, if less, only the portion of the individual's net investment income that exceeds the applicable threshold amount.

b) The modified adjusted gross income of an individual is that individual's adjusted gross income for a taxable year increased by the excess of:

(1) the amount excluded from that individual's gross income under Section 911(a)(1) [i.e. the foreign income exclusion for citizens or residents of the United States living abroad] , over

(2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under Section 911(d)(6) with respect to the amounts excluded from that individual's gross income under Section 911(a)(1).[6]

c) For purposes of the NII Tax, the term "threshold amount" means:

(1) $250,000 for taxpayers filing a joint return or a taxpayer filing as a surviving spouse;[7]

(2) $125,000 for a married taxpayer filing separately;[8] and

(3) $200,000 for in any other case.[9]

In general, if an individual has a taxable year consisting of less than 12 months (i.e. a short taxable year), the threshold amount is <u>not</u> prorated or reduced. For example, if an unmarried decedent dies on June 1, the threshold amount is $200,000 for the decedent's

5 §1411(a)(1).

6 §1411(d).

7 §1411(b)(1).

8 §1411(b)(2).

9 §1411(b)(3).

short taxable year that begins on January 1 and ends on June 1.[10] However, if the short taxable year is the result of a change in the individual's annual accounting method, then the threshold amount will be reduced.[11]

d) In general, the NII Tax applies to any citizen or resident of the United States.[12]

(1) The NII Tax does not apply to a nonresident alien (as defined in Section 7701(b)(1)(B)) .[13]

(2) In general, if a nonresident alien is married to a U.S. citizen or resident, then the spouses shall be treated as married filing separate for purposes of Section 1411.[14]

(3) However, married taxpayers who file a joint federal income tax return pursuant to a Section 6013(g) election (i.e. an election to treat the nonresident alien as a U.S. resident for purposes of filing a joint tax return), may also make a section 6013(g) election for purposes of computing their taxes under Section 1411.[15]

(a) A Section 6013(g) election is an election to treat a nonresident alien who is married to a U.S. citizen or resident as a U.S. resident to permit the filing of a joint tax return.[16]

(b) For purposes of Section 1411, the effect of a Section 6013(g) election would be to include the combined income of the U.S. citizen or resident spouse and the nonresident alien spouse and apply the threshold amount for a taxpayer filing a joint tax return.[17]

(4) A bankruptcy estate administered under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of the

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10 Prop. Treas. Reg. §1.1411-2(d)(2)(i).

11 Prop. Treas. Reg. §1.1411-2(d)(2)(ii).

12 Prop. Treas. Reg. §1.1411-2(a)(1). For purposes of Section 1411, Prop. Treas. Reg. §1.1411-2(a)(1) defines an "individual" as any natural person. However, §1411(e)(1) specifically excludes nonresident aliens.

13 §1411(e)(1); Prop. Treas. §1.1411-2(a)(1). A nonresident alien is defined in §7702(b)(1)(B) as an individual that is neither a citizen of the United States nor a resident of the United States within the meaning of §7701(b)(1)(A).

14 Prop. Treas. Reg. §1.1411-2(a)(2)(i)(A).

15 Prop. Treas. Reg. §1.1411-2(a)(2)(i)(B).

16 *See* §6013(g).

17 Prop. Treas. Reg. §1.1411-2(a)(2)(i)(B)(1).

Bankruptcy Code (Title 11 of the United States Code) of a debtor who is an individual is treated as a married taxpayer filing a separate return for purposes of Section 1411.[18]

(5) If an individual who is a bona fide resident of a U.S. territory, then their taxation under the NII Tax will depend, in part, on whether or not they are in a mirror code jurisdiction.[19]

(a) The term bona fide resident has the same meaning as provided in Section 937(a).[20]

(b) Bona fide residents of a U.S. territory that is a mirror code jurisdiction (e.g. Guam, the Northern Mariana Islands and the U.S. Virgin Islands) who properly report income and pay income tax to the tax administration of their respective U.S. territory will generally have no income tax obligation (or related tax return filing requirement) with the United States.[21] In general, these bona fide residents will not be subject to the NII Tax because they have no reporting obligation to the United States.

(c) Bona fide residents of a U.S. territory that is not a mirror code jurisdiction (e.g. Puerto Rico and American Samoa) generally have a U.S. income tax reporting obligation with respect to their U.S. source income (excluding U.S. territorial source income). Accordingly, the NII Tax is applicable to bona fide residents of non-mirror code jurisdictions if they have U.S. reportable income that gives rise to both net investment income and modified adjusted gross income exceeding the threshold amount in Section 1411.[22]

18 Prop. Treas. Reg. §1.1411-2(a)(2)(iii). Accordingly, the threshold amount for such an estate would be $125,000. *See* Treas. Reg. §1.1411-2(d)(1)(ii).

19 Prop. Treas. Reg. §1.1411-2(a)(2)(iv)(A).

20 Prop. Treas. Reg. §1.1411-2(a)(2)(iv)(C)(1). In general, a "bona fide resident" of a U.S. territory under § 937(a) means a person (i) who is present for at least 183 days during the taxable year in Guam, American Samoa, the Northern Mariana Islands, Puerto Rico or the U.S. Virgin Islands, as the case may be, and (ii) who does not have a tax home (as determined under the principles of §911(d)(3), without regard to the second sentence thereof) outside the applicable U.S. territory during the taxable year and does not have a closer connection to the United States or a foreign country than to that U.S. territory. *See* §937(a).

21 Preamble to Notice of proposed rulemaking and notice of public hearing, REG-130507-11, 77 Fed. Reg. 72611.

22 *Id*.

(d) If an individual is both a bona fide resident of a U.S. territory and a nonresident alien individual, then the individual should not be subject to the NII Tax.[23]

(e) The term U.S. territory means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico or the United States Virgin Islands.[24] .

3. Application to Estates and Trusts

a) For estates and trusts, the NII Tax is imposed on the lesser of:

(1) the undistributed net investment income for estate or trust for that taxable year, or

(2) the excess (if any) of:

(a) the adjusted gross income (as defined in Section 67(e) for that taxable year, over

(b) the dollar amount at which the highest tax bracket in Section 1(e) begins for that taxable year.[25]

b) Effectively, this results in the NII Tax being imposed on either the full amount of the estate or trust's undistributed net investment income or, if less, the portion of the trust's net investment income that exceeds highest tax bracket in Section 1(e) for the applicable tax year. For calendar year 2013, the highest tax bracket in Section 1(e) begins at $11,950.

c) Trusts and Estates taxable under Section 1411

(1) The language of Section 1411 does not specify any trusts that are excluded from the application of the NII Tax.

(2) The Proposed Regulations issued under Section 1411, however, states the general rule that the NII Tax will apply to all trusts and estates that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Code, unless

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23 *See* §1411(e)(1); Prop. Treas. Reg. §1.1411-2(a)(2)(iv)(B).

24 Prop. Treas. Reg. §1.1411-2(a)(2)(iv)(C)(2).

25 §1411(a)(2).

specifically exempted by Proposed Treasury Regulations Section 1.1411-3(b).[26]

(3) Accordingly, the NII Tax should apply to trusts that are specifically subject to the provisions of subchapter J.

(4) The NII Tax should apply to trusts that are subject to the provisions of subchapter J even though such trusts have special computational rules within those provisions. These trusts include:

(a) pooled income funds described in Section 642(c)(5);

(b) cemetery perpetual care funds described in Section 642(i);

(c) qualified funeral trusts described in Section 685;

(d) certain Alaska Native settlement trusts described in Section 646 (if that provision is in effect after the effective date of Section 1411.[27]

Note: The Treasury Department and the IRS have requested comments as to whether there may be administrative reasons to exclude one or more of these types of trusts from Section 1411. Accordingly, there could be changes to the lists of included and excluded trusts.

d) Exclusions

(1) Proposed Treasury Regulations Section 1.1411-3(b) states that the following trusts are not subject to the NII Tax:

(a) a trust all of the unexpired interests in which are devoted to certain religious, charitable, scientific, literary or educational purposes;[28]

(b) a trust exempt from tax under Section 501;[29]

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26 Prop. Treas. Reg. §1.1411-3(a)(1)(i).

27 Some practitioners have commented to the Treasury Department and the IRS that the application of §1411 under Proposed Treasury Regulations to some trusts' is inconsistent with the applicable legislative history and should be revised. *See* Letter from Kenneth Cameron of Shee Atika Inc., Comment to REG-130507-11, Guidance on Section 1411 Net Investment Income Tax (March 5, 2013) (available at 2013 Tax Notes Today, Tax Analysts Doc Number 2013-7918) (arguing that the application of the NII Tax to any electing settlement trust is inconsistent with applicable legislative history and ignores legitimate policy reasons that would exclude certain trusts from the application of §1411).

28 §1411(e)(2); Prop. Treas. Reg. §1.1411-3(b)(1).

(c) a charitable remainder trust described in Section 664;[30]

(d) any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A;[31]

(e) a trust, or portion thereof, that is treated as a grantor trust;[32] and

(f) a foreign trust.[33]

(2) Based on the language of the general rule in the Proposed Regulations, the NII Tax should also not apply to:

(a) business trusts described in Treasury Regulations Section 301.7701-4(b) that are treated as business entities under Treasury Regulations Section 301.7701-2 and as eligible entities for purposes of entity classification in Treasury Regulations Section 301.7701-3; and

(b) state law trusts that are subject to specific taxation regimes in chapter 1 other than part I of subchapter J (e.g. common trust funds taxed under Section 584 and expressly not subject to taxation under chapter 1 per Section 584(b) and designated settlement funds taxed under Section 468B in lieu of any other taxation under subtitle A per Section 468B(b)(4)).

(3) The Preamble to the Proposed Regulations indicates that the NII Tax should not apply to any trust, fund, or other special account that is exempt from tax imposed under subtitle A.

(a) The exclusion for tax exempt trusts should apply regardless of whether or not the trust is subject to unrelated business income tax.

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29 Prop. Treas. Reg. §1.1411-3(b)(2).

30 Prop. Treas. Reg. §1.1411-3(b)(3). Special rules regarding the treatment of annuity or unitrust distributions from a charitable remainder trust to persons subject to tax under §1411.

31 Prop. Treas. Reg. §1.1411-3(b)(4).

32 Prop. Treas. Reg. §1.1411-3(b)(5). In the case of a grantor trust, each item of income or deduction that is included in computing taxable income of a grantor or other person under §671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.

33 Prop. Treas. Reg. §1.1411-3(b)(6). A foreign trust is defined in §7701(a)(31)(B) and Treas. Reg. §301.7701-7(a)(2). Foreign trusts are excluded from the NII Tax except as provided in Prop. Treas. Reg. §1.1411-3(c).

(b) Examples of Code Sections providing accounts, funds or trusts exempt from the NII Tax include:

(i) tax exempt entities under Section 501(a);

(ii) a charitable remainder annuity trust or a charitable remainder unittrust under Section 664(c)(1);

(iii) an Archer MSA (i.e. a medical savings account) exempt from tax under Section 220(e);

(iv) a health savings account exempt from tax under Section 223(a);

(v) a qualified tuition program exempt from tax under Section 529(a); and

(vi) a Coverdell education savings account exempt from tax under Section 530(a).

e) Grantor trust

(1) The NII Tax is not imposed on a grantor trust or any trust or portion thereof that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1.[34]

(2) However, each item of income, deduction, or credit that are included in computing taxable income of such grantor or other person under Section 671 is treated as if it had been received by or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.[35]

f) Electing small business trusts ("ESBT")

(1) In certain instances, an ESBT that holds stock in one or more S corporations may be treated as separate trusts for purposes of chapter 1.

(2) Proposed Treasury Regulations Section 1.1411-3(c)(1) provides special computational rules for ESBTs.

(a) Under these rules, the ESBT will first separately calculate the undistributed net investment income of the S

34 Prop. Treas. Reg. §1.1411-3(b)(5).

35 *Id*.

portion and the non-S portion in accordance with the general rules for trusts under chapter 1 and then combine the undistributed net investment income of the S portion and the non-S portion to calculate the ESBT's undistributed net investment income.

(b) Second, the ESBT will determine its adjusted gross income, solely for purposes of Section 1411, by adding the net income or net loss from the S portion to the non-S portion as a single item of ordinary income or ordinary loss.

(c) Finally, to determine whether the ESBT is subject to Section 1411, and if so, the Section 1411 tax base, the ESBT will compare the combined undistributed net investment income with the excess of its adjusted income over the Section 1(e) threshold (i.e. the dollar amount at which the highest tax bracket in Section 1(e) begins for the taxable year).

(3) This results in the ESBT being treated as separate trusts for purpose of computing the amount of undistributed net investment income of each separate trust within the ESBT but consolidates the ESBT into a single trust for purposes of determining the adjusted gross income threshold in Section 1411(a)(2)(B)(ii).

g) Charitable remainder trusts

(1) Proposed Treasury Regulations Section 1.1411-3(c)(2) provides special computational rules for charitable remainder trusts.

(2) Although a charitable remainder trust is not subject to the NII Tax, annuity and unitrust distributions from the trust may be net investment income to the non-charitable beneficiary.[36]

(a) Distributions from a charitable remainder trust to a beneficiary for a taxable year consist of net investment income in an amount equal to the lesser of the total amount of the distributions for that year, or the current and accumulated net investment income of the charitable remainder trust.

36 Prop. Treas. Reg. §§1.1411-3(b)(3) & (c)(2).

(b) Accumulated net investment income is defined as the total amount of net investment income received by a charitable remainder trust for all taxable years beginning after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years.

(c) Under the Proposed Treasury Regulations, current and accumulated net investment income of the trust is deemed to be distributed before amounts that are not items of net investment income for purposes of Section 1411.

(3) The Preamble to the Proposed Treasury Regulations indicates that the Treasury Department and the IRS considered an alternative method for determining the distributed amount of net investment income in which net investment income would be determined on a class-by-class basis within each of the categories enumerated in Treasury Regulations Section 1.664-1(d)(1). Although the Preamble indicates that the Treasury Department and the IRS believed that the recordkeeping and compliance burden that would be imposed on trustees by this alternative method would outweigh the benefits, some practitioners have asked Treasury and the IRS to include this as an alternative method and permit trustees to make the cost vs. benefit determination.[37]

h) Foreign estates and trusts

(1) As a general rule, foreign estates and trusts are not subject to the NII Tax.[38]

(2) The Treasury Department and the IRS believe, however, that net investment income of a foreign estate or foreign trust should be subject to the NII Tax to the extent that the trust's or the estate's income is earned, accumulated for the benefit of, or distributed to, United States persons. Accordingly, Proposed Treasury Regulations Sections 1.1411-3(d)(2)(ii) and 1.1411-3(c)(3) are reserved for the application of Section 1411 to foreign estates and foreign trusts with United States beneficiaries.

i) Bankruptcy estates

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37 *See* Letter from Tina Green of the State Bar of Texas Section of Tax, Comments of the State Bar of Texas, Tax Section on Proposed Regulations Regarding Net Investment Income Tax under Section 1411 of the Internal Revenue Code (March 4, 2013) (available at 2013 Tax Notes Today, Tax Analysts Doc Number 2013-5216).

38 Prop. Treas. Reg. §§1.1411-3(d)(2).

(1) As stated above, a bankruptcy estate administered under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of the Bankruptcy Code (Title 11 of the United States Code) of a debtor who is an individual is treated as a married taxpayer filing a separate return for purposes of Section 1411.[39]

(2) Accordingly, the threshold amount applicable to a bankruptcy estate is $125,000.

j) Calculation of undistributed net investment income

(1) As stated above, for estates and trusts, the NII Tax is imposed on the lesser of (a) the undistributed net investment income of the estate or trust for such year, or (b) the excess (if any) of the adjusted gross income (as defined in Section 67(e) for the taxable year, over the dollar amount at which the highest tax bracket in Section 1(e) begins for such taxable year.

(2) The term "undistributed net investment income" is a Section 1411 term used solely for estates and trusts (and not for individuals). The Proposed Treasury Regulations are intended to conform the taxation of estates and trusts under Section 1411 to the rules of part I of subchapter J to avoid double taxation of net investment income and the taxation of amounts distributed to charities.

(3) Accordingly, the "undistributed net investment income" for an estate or trust is that estate's or trust's net investment income (as determined under Proposed Treasury Regulations Section 1.1411-4) reduced by the share of net investment income included in the deductions of the estate or trust under Section 651 or Section 661, and the share of net investment income allocated to the Section 642(c) deduction of the estate or trust in accordance with Treasury Regulation Section 1.642(c)-2(b) and the allocation and ordering rules under Treasury Regulations Section 1.662(b)-2.[40]

(4) In the case of distributions that are comprised of both net investment income and net excluded income items, the Proposed Treasury Regulations adopt the class system of income categorization, generally embodied in Sections 651 through 663 and the Treasury Regulations thereunder.

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39 Prop. Treas. Reg. §1.1411-2(a)(2)(iii).

40 Prop. Treas. Reg. §§1.1411-3(e).

II. Net Investment Income

A. Categories of Net Investment Income

1. Types of Net Investment Income. The term "net investment income" includes three types of income:

a) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business with respect to which the NII Tax does not apply;[41]

b) other gross income from a trade or business to which the NII Tax does apply;[42] and

c) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the NII Tax does not apply.[43]

B. *Section 1411(c)(1)(A)(i) Income.* This is generally gross income from interest, dividends, annuities, royalties and rents not derived in the ordinary course of a trade or business.

1. Interest and Dividends

a) For purposes of the NII Tax, gross income from interest includes any item treated as interest or as a dividend for purposes of chapter 1.[44]

b) Gross income from interest also includes substitute payments that are treated in the same manner as actual interest or dividend payments.

c) Gross income from dividends also includes amounts treated as dividends such as amount treated as constructive dividends, amounts treated as dividends under Section 1248(a) (i.e. the rules dealing with sales of stock of controlled foreign corporations) and Section 1368(c)(2) (i.e. distributions by an S corporation that are treated as a distribution of undistributed C corporation earnings and profits).[45]

2. Notional Principal Contracts

41 §1411(c)(1)(A)(i).

42 §1411(c)(1)(A)(ii).

43 Section 1411(c)(1)(A)(iii).

44 Preamble to notice of proposed rulemaking, REG-130507-11, 77 Fed. Reg. 72611, 72617.

45 *Id.* At 72618.

a) The income gross income from notional principal contracts (within the meaning of Treasury Regulations Section 1.446-3(c)) is not included in net investment income under Section 1411(c)(1)(A)(i). However, if the gross income from notional principal contracts is derived in a trade or business described in Proposed Treasury Regulations Section 1.1411-5, then all such gross income is included in net investment income under Section 1411(c)(1)(A)(ii).

b) Gain on the disposition of a notional principal contract is included in net investment income under either Section 1411(c)(1)(A)(ii) or Section 1411(c)(1)(A)(iii).

3. Annuities

a) Gross income from annuities includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includable in gross income.[46]

b) Gain or loss from the sale of an annuity is also included in gross income for purposes of Section 1411.

(1) If the sales price of the annuity does not exceed its surrender value, the gain recognized is treated as gross income under Section 1411(c)(1)(A)(i).

(2) If the sales price of the annuity exceeds is surrender value, then the seller treats the gain equal to the difference between the basis in the annuity and its surrender value as gross income under Section 1411(c)(1)(A)(i) and the excess of the sales price over the surrender value as gain from the disposition of property under Section 1411(c)(1)(A)(iii).

4. Royalties and Rents

a) Gross income from royalties includes amounts received mineral, oil and gas royalties. It also includes amounts received from patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises and other like property.

b) Gross income from rents includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

5. Ordinary Course of a Trade or Business Exception

46 *Id*.

a) An item included as net investment income under Section 1411(c)(a)(A)(i) (e.g. interest, dividends, annuity income, royalties, and rent) may be excluded from net investment income if the item of income meets a two part ordinary course of a trade or business exception.

b) The two part test requires:

(1) First, the item must be "derived in" a trade or business not described in Section 1411(c)(2).

(2) Second, the item must be derived in the "ordinary course" of such trade or business.

c) Derived In

(1) The item of income cannot be derived in a trade or business described in Section 1411(c)(2). Under Section 1411(c)(2) the following trades or businesses are not eligible for the ordinary trade or business exception:

(a) a trade or business that is a passive activity (within the meaning of Section 469) with respect to the taxpayer; and

(b) a trade or business that is in the business of trading in financial instruments (as defined in Proposed Treasury Regulations Section 1.1411-5(c)(1)) or commodities (as defined in Section 475(e)(2)).

(2) The determination as to whether the trade or business is a passive activity with respect to a taxpayer is done at the individual level. The determinations as to whether the activity is a trade or business and whether it is in the business of trading securities or commodities are done at the entity level.

(3) For example, if an individual owns shares in an S corporation or an equity interest in a partnership, then in order for the income allocated to that individual to be meet the "derived in" requirement:

(a) the business cannot be in the business of trading in financial instruments (determined at the entity level);

(b) the activities of the trade or business generating the income cannot be treated as a passive activity of the individual (as determined under the passive loss rules of

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Section 469 at the individual level based on the activities of the individual); and

(c) the income must be derived in business that is a trade or business (determined at the entity level).

(4) The preamble to the Proposed Treasury Regulations provides an example of a shareholder in an S corporation that is a bank. In the example, if the S corporation earns interest income as part of its trade or business of banking and a portion of that income is allocated to the shareholder, then the income would be not be treated as net investment income if the banking activity of the S corporation was treated as an active activity of the shareholder (as determined under Section 469 and the applicable Treasury Regulations thereunder). Alternatively, if the banking activity of the S corporation was treated as a passive activity of the shareholder (as determined under Section 469 and the applicable Treasury Regulations thereunder), then the interest income would be included in the shareholder's net investment income for that year.

d) Ordinary Course

(1) Neither Section 1411 nor the Proposed Treasury Regulations define the term ordinary course of a trade or business.

(2) The Preamble to the Proposed Treasury Regulations does indicate that other Treasury Regulations and case law provide guidance as to whether an item of gross income is derived in the ordinary course of a trade or business.[47]

e) Income from employment

(1) For purposes of Section 1411, an employee is treated as engaged in the trade or business of being an employee.

(2) Amounts paid by an employer to an employee that are treated as wages for purposes of Section 3401 are not net

[47] Preamble to notice of proposed rulemaking, REG-130507-11, 77 Fed. Reg. 72611, 72619. The Preamble referenced *Lily v. Commissioner*, 343 U.S. 90, 93 (1953) (holding that expenses incurred regularly and arising from transactions that commonly or frequently occur in the type of business involved are "ordinary") and Treasury Regulations §1.469-2T(c)(3)(ii) (providing rules for determining whether certain portfolio income is excluded from the definition of passive activity gross income) as examples of existing authorities for making this determination.

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investment income because such amounts are derived in the ordinary course of a trade or business to which Section 1411 does not apply.

(3) Thus amounts paid to an employee under a nonqualified deferred compensation plan for such employee (including amounts that otherwise become includable in income under Sections 409A, 457(f), 457A or other Code Section or tax doctrine) that include gross income from interest or other earnings are not treated as net investment income, regardless of whether such amounts are not subject to the Federal Insurance Contributions Act tax due to the earlier application of Section 3121(v)(2).

f) Coordination with portfolio income rules of Section 469

(1) Portfolio income that is not derived in the ordinary course of a trade or business under Section 469.

(2) Accordingly, portfolio income that is not derived in the ordinary course of a trade or business does not qualify for the ordinary course of a trade or business exception and is included as net investment income.

C. Other trade or business gross income described in Section 1411(c)(1)(A)(ii)

1. Net investment income includes gross income derived from a trade or business described in Section 1411(c)(2).

2. Accordingly, Section 1411(c)(2) will pick up any gross income from a passive activity with respect to a taxpayer that is not already picked up as gross income described in Section 1411(c)(1)(A)(i) or Section 1411(c)(1)(A)(iii).

3. Section 1411(c)(2) will also pick up all income derived from a business that is a trade or business of trading in financial instruments or commodities. The will include mark-to-market gains under Section 475(f) or Section 1256 and any realized gain from the disposition of property held in the trade or business of trading in financial instruments or commodities.

D. Net gain described in Section 1411(c)(1)(A)(iii)

1. General Rule. Section 1411(c)(1)(A)(iii) states that net investment income includes net gain (to the extent taken into account in computing taxable income)

attributable to the disposition of property other than property held in a trade or business not described in Section 1411(c)(2).

2. Disposition

a) Except as otherwise provided, the determination as to whether a disposition of property has occurred will be determined under the tax rules of chapter 1.

b) Under these rules, a disposition of property will include transactions that are treated as a disposition of property for federal income tax purposes.

c) Thus, for purposes of determining a taxpayer's net investment income, gain from the disposition of property could include:

(1) a partner receiving a distribution of money in excess of the partner's tax basis under Section 731(a);

(2) an S corporation shareholder receiving a distribution of money from an S corporation in excess of the adjusted basis of the shareholder's stock in the corporation and recognizing gain under Section 1368(b)(2);

(3) capital gain dividends from regulated investment companies and real estate investment trusts described in Sections 852(b)(3)(C) and 857(b)(3)(C), respectively, and undistributed capital gains described in Sections 852(b)(3)(D) and 857(b)(3)(D);

(4) gains and losses from a deemed asset sale on the sale of the stock of an S corporation under Section 338(h)(10).

d) Mark-to-market rules for non-traders. If a non-trader is required to mark assets to market (e.g. under Section 1256), the gains and losses recognized as a result of marking to market are generally treated as net investment income.

3. Determination of net gain from disposition

a) Except as otherwise expressly provided in the Proposed Treasury Regulations, the general income tax rules for determining recognition of gain and loss will apply for purposes of determining net gain under Section 1411.

b) For example, if gain or loss is not recognized as a result of a like-kind exchange in accordance with Section 1031, then gain or loss will also not be recognized for purposes of determining net investment income under Section 1411.

c) The Preamble to the Proposed Regulations indicates that because Section 1411(c)(1)(A)(iii) uses the term net gain (which contemplates a positive number), the amount of net gain included in net investment income may not be less than zero.

4. Exception for property held in a trade or business not described in section 1411(c)(2)

a) If the property that is disposed of is "held" in a trade or business and such trade or business is not described in Proposed Treasury Regulation section 1.1411-5, net investment income would not include gain attributable to such property.

b) The determination of whether property is "held" in a trade or business is determined in the same manner as whether gross income is "derived in" a trade or business for purposes of Section 1411(c)(1)(A)(i).

c) For example, if an S corporation sells property, the determination as to whether the sold property was held in a trade or business is determined at the S corporation level. However, if the shareholder of an S corporation sells stock in the S corporation, the determination as to whether the sale of stock was "held" in a trade or business is determined at the shareholder level.

E. *Distributions from trusts.* Net investment income includes a beneficiary's share of distributable income, as described in Sections 652(a) and 662(a), to the extent that, under Sections 652(b) and 662(b), the character of such income constitutes net investment income.

F. Properly allocable deductions

1. In determining net investment income, items of gross income and net gain are reduced by properly allocable deductions.

a) The principles applied in determining the amount and the timing of a deduction for general federal income tax purposes apply for purposes of determining a deduction under Section 1411.

b) In addition, only amounts paid or incurred by a taxpayer to produce the gross income or net gain included in net investment income may be deducted against such income for purposes of the NII Tax.

2. Net investment income cannot be less than zero. Deductions otherwise allocable for purposes of Section 1411 may be carried over to offset net investment income in future years only to the extent such deductions are allowed to be carried over for other federal income tax purposes under chapter 1.

a) For example, carryforwards are permitted for:

(1) investment income expense under Section 163(d)

(2) suspended passive activity losses under Section 469(b)

(3) capital loss carryforwards under Section 1212.

b) Currently, the Proposed Treasury Regulations do not permit net operating loss carryforwards to be used to offset net investment income in future years. The reasoning of the IRS is that tracing the portion of net operating loss carryforwards allocable to the net investment income would be unduly complex and not administrable. The Treasury Department and the IRS have asked for comments on this issue.

c) Itemized deductions that are subject to the 2-percent floor on miscellaneous itemized deductions under Section 67 or subject to the overall limitation on itemized deductions under Section 68 may be deducted in determining net investment income only to the extent that they are deductible for income tax purposes after the application of the 2-percent floor and the overall deduction limitation.

G. Section 1411 Trades or Businesses and application of Section 469 to Section 1411

1. The Preamble to the Proposed Regulations indicates that the Proposed Regulations incorporate the rules under Section 162 for determining whether an activity is a trade or business for purposes of Section 1411.

2. Trade or business that is a passive activity with respect to the taxpayer

a) The statutory language in Sections 1411(c)(1)(A) and 1411(c)(2)(A) is intended to take into account only gross income from and net gain attributable to a passive activity (within the meaning of Section 469) that involved the conduct of a trade or business (within the meaning of Section 162).

(1) Due to differences in the definitions of a trade or business for purposes of Section 1411 and the passive loss rules of Section 469, some activities that are trades or businesses for Section 469 purpose are not trades or businesses for purposes of Section 1411.

(2) Section 469 includes research or experimentation activities (within the meaning of Section 174) in addition to trades or businesses within the meaning of Section 162.

(3) In addition, although Section 469 defines passive activities under Section 469 as any trade or business in which the taxpayer does not materially participate it also includes any rental activity.

b) Application of existing Section 469 rules

(1) Section 469(c)(1) provides that a passive activity is any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate.

(2) Section 469(c)(2) proves that except as otherwise provided, a rental activity is a passive activity (regardless of whether the taxpayer materially participates in the rental activity).

(3) As a general rule, the determination as to whether a trade or business is passive for purposes of Section 1411 is the same as the determination under Section 469. It is based on whether the taxpayer materially participates in the trade or business.

(a) However, activities that do not rise to the level of a Section 162 trade or business, are not treated as a trade or business for Section 1411 purposes.

(b) In that case, the income from that business would not be eligible for the ordinary course of trade or business exception and the income would flow through to the owners of the business and be taxed under either Section 1411(a)(1)(C)(i) or Section 1411(a)(1)(C)(iii).

(4) Material Participation. To be treated as materially participating in a trade or business, the taxpayer's participation in the operations of the activity must be on a basis which is regular, continuous, and substantial.[48] The Treasury Regulations issued under Section 469 provide additional guidance for individuals on the meaning of "material participation", including several safe harbors based on the amount of participation by the taxpayer in a given tax year.

(5) Real estate professionals. Section 469(c)(7) and Treasury Regulations Section 1.469-9 provide special rules for certain real estate professional. If a taxpayer meets the requirements of

48 §469(h)(1).

Section 469(c)(7)(B), the taxpayer's interests in rental real estate are no longer subject to Section 469(c)(2) and the rental real estate activities of the taxpayer will not be passive.[49]

(a) This exception will also apply to Section 1411 if the activity qualifies as a Section 162 trade or business.

(b) If the activity does not qualify as a Section 162 trade or business, then the rents from real estate will be included as net investment income under Section 1411(c)(1)(A)(i). The ordinary course of trade or business exception would not be applicable because the rents were not derived from a trade or business for purposes of Section 1411.

(6) Rental activity exceptions.

(a) In general, the exceptions as to what constitutes a rental activity under Section 469 will also apply to Section 1411.[50]

(b) However, if the activity involved in the exception does not rise to the level of a Section 162 trade or business, then the gross income from rents from the activity will be subject to Section 1411(c)(1)(A)(i).[51]

(7) Grouping rules

(a) Treasury Regulation Section 1.469-4 provides rules to permit some activities to be grouped together for purposes of applying the passive loss limitation rules of Section 469. In general, these grouping rules will also apply for purposes of applying Section 1411.

(b) However, a proper grouping of rental activities with other activities in accordance with Treasury Regulations Section 1.469-4(d)(1) (grouping rental activities with other trade or business activities) may not convert gross income from rents into other gross income derived from a Section 162 trade or business for purposes of Proposed Treasury Regulations Section 1.1411-5(a)(1).

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49 In general, Section 469(c)(7)(B) requires that: (i) more than half of the personal services performed by the taxpayer in the tax year are performed in real estate activities in which the taxpayer materially participates and (ii) the taxpayer perform at least 750 hours in such activities.

50 *See, e.g.* Treas. Reg. §1.469-1T(e)(3)(ii).

51 *See* Treas. Reg. §1.1411-5(b)(2), Examples 3 and 4.

(c) In general, the Treasury Regulations under Section 469 indicate that once a taxpayer has grouped their activities for purposes of Section 469, they are not permitted to regroup these activities in subsequent years except in certain circumstances.[52]

(d) However, the Proposed Treasury Regulations under Section 1411 provide taxpayers a "fresh start" to redetermine their groupings and permit taxpayers to regroup their activities in the first taxable year beginning after December 31, 2013, in which the taxpayer meets the applicable income threshold in Proposed Treasury Regulations Section 1.1411-2(d) and has net investment income (as defined in Proposed Treasury Regulations Section 1.1411-4). A taxpayer may only regroup activities once and any such regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.

c) Characterization of Income Rules

(1) Section 469 contains certain recharacterization rules that may recharacterize passive income as non-passive and vice versa. In general, these rules will also apply to Section 1411.

(2) Portfolio income is defined as income that is not derived in the ordinary course of a trade or business. Accordingly, portfolio income, by definition, is treated as net investment income under Section 1411(c)(1)(A)(i) unless an exception applies.

(a) Treasury Regulations Section 1.469-7 provides an exception to the portfolio rules for self-charged interest (e.g. interest between pass-through entities and their owners). Under this rule, interest income is recharacterized from portfolio income to passive income. This results in a partner or an S corporation shareholder allocated interest income to be able to offset it with the owner's distributive share of passive interest expense from the same lending transaction.

(b) The Proposed Treasury Regulations do not specifically address the treatment of self-charged interest. However, the Preamble to the Proposed Treasury Regulation indicate that such self-charged interest would be treated as passive income and, as such, would be gross

52 *See* Treas. Reg. §§1.469-4(e)(1), (e)(2) and -11.

income from interest subject to proposed Treasury Regulations Section 1.1411-4(a)(1)(i). Treasury Regulations Section 1.1411-4(a)(1)(i) includes in net investment income all interest not derived in the ordinary course of a trade or business.

(c) Practitioners have raised concerns that the reference to Treasury Regulations Section 1.1411-4(a)(1)(i) could cause self-charged interest to be treated as interest under not derived in the ordinary course of a trade or business (i.e. Section 1411(a)(1)(C)(i) interest) rather than passive interest and have asked that the Treasury Department and IRS clarify this point in the final regulations.[53]

(3) The Treasury Regulations under Section 469 contain special rules that will treat income from certain activities as not from a passive activity.[54] If the item of income from these activities constitutes gross income from one of the items described in Treasury Regulations Section 1.1411-4(a)(1)(i) and the item of income is not derived in the ordinary course of a trade or business, then this income may be subject to tax under Section 1411.

III. Limitation on Gains and Losses on Dispositions of Interests in Partnerships and S corporations

A. *Exception to the General Rule*. Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or an S corporation, gain from such disposition shall be taken into account under Section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under Section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) provides a similar rule with respect to losses recognized from the disposition of an interest in a partnership or an S corporation.

1. In general, an interest in a partnership or an S corporation would not be treated as being held in a trade or business. Accordingly, gains and losses from

53 *See* Letter from Michael J. Grace, dated March 5, 2013) (available at 2013 Tax Notes Today, Tax Analysts Doc Number 2013-5237).

54 *See, e.g.* Treas. Reg. §1.469-2T(f)(2) (special rule for significant participation); Treas. Reg. §1.469-2T(f)(3) (rental of nondepreciable property); Treas. Reg. §1.469-2T(f)(4) (net interest income from passive equity-financed lending activity); Treas. Reg. §1.469-2(f)(5) (net income from certain property rented incidental to development activity); Treas. Reg. §1.469-2(f)(6) (property rented to a nonpassive activity); Treas. Reg. §1.469-2T(f)(7) (special rules applicable to the acquisition of an interest in a pass-through entity engaged in the trade or business of licensing intangible property).

the sale of such an interest would generally be treated as net investment income under Section 1411(c)(1)(A)(iii).

2. However, Section 1411(c)(4) provides an exception to this general rule. If the partnership or the S corporation qualified for the ordinary course of trade or business exception, Section 1411(c)(4) can substantially reduce or eliminate the gains or losses otherwise recognized by a taxpayer on a sale of their interest in a partnership or S corporation.

3. Since the inside tax basis of the assets of a partnership or an S corporation may be different from the taxpayer's outside tax basis in their interest in the partnership or S corporation, a taxpayer could still have to recognize some gain or loss even if the partnership or S corporation does qualify for the ordinary course of a trade or business exception.

4. In addition, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.

5. The Section 1411(c)(4) exception is applied on a property-by-property basis. The exception does not apply to property held in a trade or business described in Section 1411(c)(2) (i.e. a passive business with respect to the taxpayer or a securities or commodities trading business). The exception also does not apply where there is no trade or business.

B. Mechanics of Section 1411(c)(4)

1. The Proposed Treasury Regulations use a multi-step approach to apply Section 1411(c)(4). A transferor computes the gain or loss from the sale of the underlying properties of the partnership or S corporation based on a deemed asset sale. Then the taxpayer determines if, based on the deemed sale, there is a positive or negative adjustment that must be made to the transferor's gain or loss on the disposition of the partnership or S corporation interest.

2. The deemed sale is described in the Proposed Treasury Regulations as a four step process:

a) First, all of the entity's properties (including goodwill) are sold in a fully taxable transaction for each equal to the fair market value of the entity's properties immediately before the disposition of the interest.

b) Second, gain or loss is calculated on each of the entity's properties (including goodwill).

c) Third, portion of each gain or loss that would be allocated to the taxpayer is determined.

(1) If the entity is a partnership, then the amount of gain or loss allocable to the partner must take into account the terms of the partnership agreement and applicable provisions of the Code (e.g. allocations under Section 704(b), Section 704(c) or basis adjustments under Section 743 with respect to the transferor).

(2) If the entity is an S corporation, then amount of gain or loss allocated to the shareholder would be determined under Section 1366(a). The allocation should not, however, take into account any reduction in the transferor's distributive share in Section 1366(f)(2) that would result from the hypothetical imposition of tax under Section 1374 as a result of the deemed sale.

d) Lastly, the transferor determines, based on the deemed sale and allocations, the amount of gain or loss allocated to the transferor with respect to each property would have been taken into account in determining the taxpayer's net gain under Section 1411(c)(1)(A)(iii) if the transaction had been an actual sale.

(1) If the entity's property is either held in a trade or business described in Section 1411(c)(2) or is not held in a trade or business, then where will be no adjustment under Section 1411(c)(4).

(2) If the entity's property is held in a trade or business not described in Section 1411(c)(2), there is an adjustment under Section 1411(c)(4).

(a) If there is a net gain there will be a negative adjustment and if there is a net loss there will be a positive adjustment.

(b) The negative adjustment or positive adjustment is made to the gain or loss on the sale of the interest in the partnership or S corporation.

C. Special situations

1. Section 338(h)(10) Election. In the case of a disposition of S corporation stock where a Section 338(h)(10) election is made, no adjustment under Section 1411(c)(4) is necessary because the Section 338(h)(10) election already creates a transaction treated as an actual asset sale for federal income tax purposes.

2. Installment Sales. If the disposition of an interest in a partnership or an S corporation involves an installment sale to which Section 453 applies, then the

adjustment to net income is calculated in the year of the disposition.[55] In that case, the gain and any adjustment are deferred and recognized proportionately pursuant to Section 453.[56] proportionate accomplished using an disposed of in an installment

3. Statement. Any transferor that makes an adjustment under Proposed Treasury Regulation 1.1411-7(c)(5) must attach a statement to the transferor's tax return for the year of disposition.

a) The statement must include various information including:

(1) a description of the disposed of interest,

(2) the name and taxpayer identification number of the entity disposed of;

(3) the fair market value of each property of the entity;

(4) the entity's adjusted tax basis in each property;

(5) the transferor's allocable share of gain or loss with respect to each property;

(6) information regarding whether the property was held in a trade or business not described in Section 1411(c)(2);

(7) the amount of the Section 1411(c)(1)(A)(iii) gain on the disposition of the interest; and

(8) the computation of the adjustment under Proposed Treasury Regulations Section 1.1411-7(c)(5).

4. Comments. The Treasury Department and IRS recognize that the approach of the Proposed Treasury Regulations may impose an administrative burden on owners of partnerships and S corporation in certain circumstances and have requested comments on other methods that would implement the provisions of Section 1411(c)(4) without imposing an undue burden on taxpayers.

D. Exception for items subject to Self-Employment Tax

55 Prop. Treas. Reg. §§1.1411-7(b)(1)(i).

56 Prop. Treas. Reg. §§1.1411-4(a)(1)(iii).

1. Section 1411(c)(6) indicates that net investment income does not include any item taken into account in determining self-employment income for such taxable year in which a tax is imposed under Section 1401(b).

a) Section 1401(b) imposes a 2.9% Medicare tax on the self-employment income of individuals.

b) For amounts in excess of certain threshold amounts, the rate is increased by an additional 0.9 percent to a total of 3.8%.

2. In general, the term self-employment income means the net earnings from self-employment (as defined under Section 1402(a)) derived by an individual.[57] However, if the amount of self-employment income is less than $400 in a taxable year, then the amount of self-employment income for that taxable year shall be treated as zero.

3. In general, net investment income (as defined in Proposed Treasury Regulations Section 1.1411-4) does not include any item taken into account in determining self-employment income that is subject to tax under Section 1401(b) for such taxable year. [58]

a) For purposes of Section 1411(c)(6), an item is "taken into account" if the income is included and deductions allowed in determining net earnings from self-employment.

b) However, amounts that are excluded from and not included in determining self-employment income for purposes of Section 1402(b), may be included in net investment income if such amounts are described in Proposed Treasury Regulations Section 1.1411-4.

IV. Special Rules for CFCs and PFICs

A. The Proposed Treasury Regulations contain detailed provisions describing how the NII Tax applies to controlled foreign corporations and passive foreign investment companies.[59] In general, the amounts treated as dividends or gains will be treated similarly under the NII Tax rules.

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57 Section 1402(b).

58 Prop. Treas. Reg. §1.1411-9(a).

59 *See* Prop. Treas. Reg. §1.1411-9(a).

B. A detailed analysis of these rules is beyond the scope of this outline. See Proposed Treasury Regulations Section 1.1411-10.

V. Interaction between the NII Tax and the Medicare Taxes on Wages and Self-Employment Income

A. *Three Medicare Tax Regimes*. At the same time Congress enacted the 3.8% tax on net investment income, it also increased the Medicare tax imposed on employee wages and on self-employment income. Like the NII Tax, these increses became effective for tax years beginning after 12-31-2012. As a result there are the three tax regimes that impose additional Medicare taxes.[60]

1. Medicare tax on employee wages

a) The employee's portion of the hospital insurance tax on wages received was increased by 0.9% on wages received over specified threshold amounts.[61] The threshold amounts are the same threshold amounts used for calculating the NII Tax.[62]

b) This raised the employee's portion of hospital insurance taxes imposed on employee wages from 1.45% to 2.35%. When combined with the 1.45% hospital insurance tax imposed on the employee wages by the employor, this new Medicare tax raised the total rate paid on employee wages for hospital insurance to 3.8%

c) This additional 0.9%, like the prior 1.45% of hospital insurance tax paid by the employee, is not deductible by the employee.[63]

2. Medicare tax on self-employment income

a) The hospital insurance tax on self-employment income was raised by 0.9% for self-employment income over specified threshold amounts.[64] The threshold amounts are the same threshold amounts used for calculating the NII Tax and the Medicare tax on employee wages.[65]

b) This increased the total amount of hospital insurance tax imposed on self-employment income to 3.8%.

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60 *See* Schuyler M. Moore, "The Three 3.8 Percent Tax Regimes" BNA Daily Tax Report, February 22, 2013, for an excellent article on the interplay of these three taxes.

61 §3101(b)(2).

62 §3101(b)(2)(A)-(C). These thresholders are $250,000 for joint tax returns, $125,000 for married filing separate and $200,000 in all other cases.

63 §3101(a).

64 §1401(b)(2).

65 §1401(b)(2)(A)-(C).

c) Unlike other portions of self-employment taxes, this additional 0.9% is not deductible by the self-employed person.

d) The definition of self-employment income is broad and can pick up items that some people might not natually associate with self-employment income.[66]

3. Medicare tax on net investment income

a) The NII Tax is also a 3.8% tax. The NII Tax is imposed on net investment income over the same threshold amounts used for the additional Medicare tax on employee wages and on self-employment income.

b) Between the three tax regimes, much of the income recognized by individuals is subject to these additional Medicare taxes.

B. Exceptions. Despite casting a wide Medicare tax net, Congress still left some income on individuals, trusts and estates free from these three Medicares tax regimes. The following is a short list of some of the income not subject to any of the three Medicare taxes.

1. Active S corpoation income. Allocated income from a trade or business income (other than a securities or currencies trading business or a trade or business that is a passive activity with respect to the shareholder receiving the income allocation) that is conducted by an S corporation.

a) In general, income allocations from an S corporation to a shareholder in that S corporation are not self employment income.[67] Unless recharacterized by the IRS, this income is also not wages.

b) Accordingly, as long as this income meets the ordinary course of a trade or business exception to the NII Tax, this income would escape taxation from all three of the Medicare regimes.

2. Gain on the Sale of an Interest in an Active Partnership or Active S corporation. Gains recognized on the sale or other taxable disposition of an interest in a partnership or an S corporation to the extent such gain or loss would not have been subject to the NII Tax if the partnership or S corporation had sold all of the assets of such entity for its then fair market value.

a) This exception does not apply to a partnership that is involved in a securities or currencies trading business.

66 *See, e.g.*, §1402(a)(13) (guaranteed payments under §704(c)); Treas. Reg. §1.1402(a)-1(a)(2) (distributive share of a general partner in a partnership, regardless of whether such income is the result of services).

67 Rev. Rul. 59-221, 1959-1 CB 225.

b) This exception also does not apply to the sale of an interest in a partnership or S corporation to the extent that the trade or business of the entity would be treated as a passive activity with respect to the partner or shareholder selling their interest.

c) Furthermore, this exception also does not apply to the portion of gains or losses allocable to assets of the partnership or the S corporation that are not treated as being held as part of the active trade or business of the partnership or S corporation.

d) Finally, this exception does not apply to the portion of the gain allocable to the difference between the inside and outside basis in the partnership's or S corporation's assets and interests.

3. Distributions from Qualified Plans. The term "net investment income" does not include any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b).

4. Certain other miscellaneous items.[68] These items include:

a) Alimony;[69]

b) Retirement payments to partners from a partnership engaged in a trade or business if the partners materially participate in such trade or business at the time of retirement;

c) Lottery/Gambling winnings.[70]

68 *See* Schuyler M. Moore, "The Three 3.8 Percent Tax Regimes" BNA Daily Tax Report, February 22, 2013.

69 *See* Answer to Question 8 in Net Investment Income Tax Fax on IRS.Gov.

70 Lottery/gambling winnings were not specifically addressed in §1411 or in the Proposed Treasury Regulations issued under §1411. However, these items would not be treated as wages or self-employment income and would not fall within the definition of net investment income. Accordingly, an argument may be made that this type of income, except for the professional gambler, should escape all three Medicare tax regimes.

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FIDUCIARY DUTIES 101
FOR CHARITY MANAGERSAND THEIR LEGAL COUNSEL

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I. OVERVIEW.

Lawyers who represent tax-exempt organizations must regularly meander through the statutory maze of excise taxes governing private foundations, donor-advised funds, public charities and certain other nonprofit entities. Many of these excise tax provisions in effect regulate fiduciary behavior. The same observation is true of certain basic requirements a charitable entity must meet so as to qualify for federal income tax exemption. For further discussion of these observations, see Johnny Rex Buckles, *The Federalization of Fiduciary Obedience Norms in Tax Laws Governing Charities: An Introduction to State Law Concepts and an Analysis of their Implications for Federal Tax Law*, 4 EST. PLAN. & COMMUNITY PROP. L. J. 197 (2012); Johnny Rex Buckles, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries under United States Tax Law*, 99 KY. L. J.645 (2011); Johnny Rex Buckles, *Fiduciary Assumptions Underlying the Federal Excise Taxation of Compensation Paid by Charities*, 45 REAL PROP. TR. & EST. L. J. 53 (2010).

Nevertheless, as significant as federal tax law is in regulating the conduct of charity fiduciaries, tax lawyers must also master the state law that governs the managers of their nonprofit clients. Understanding state law enables the tax lawyer (1) to advise clients how not to invite a lawsuit by the state attorney general or some other party with standing to sue; (2) to help clients understand principles of good governance (both for its own sake, and because of the importance that the Internal Revenue Service has placed on governance in recent years); (3) to better evaluate the advisability of efforts to reform state law and federal tax law; and (4) to reduce the likelihood of committing malpractice!

This Article discusses the general fiduciary duties imposed on members of the governing board of a Texas nonprofit corporation, and the standards used to determine whether a director has discharged his or her duties. This Article also discusses the fiduciary duties imposed on trustees of charitable trusts, and the standard of care applicable in special circumstances (including the management of investments). Basic issues of professional responsibility arising from a legal advisor's representation of nonprofit entities will also be discussed.

This Article employs the following abbreviations: (1) "TBOC" means the Texas Business Organizations Code; (2) "TTC" means the Texas Trust Code (i.e., the sections of the Texas Property Code governing the law of trusts and trustees); and (3) "TUPMIFA" means the Texas version of the Uniform Prudent Management of Institutional Funds Act.

II. FIDUCIARY DUTIES GOVERNING DIRECTORS OF A NONPROFIT CORPORATION.

A. Duties of Directors and Standards for Discharging those Duties.

Traditionally, legal authorities state that directors of nonprofit corporations owe a duty of care and a duty of loyalty. As discussed below, some authorities further articulate a distinct "duty of obedience" that is owed by directors. Texas statutory law largely codifies the duties of care and loyalty with some degree of specificity. This section of the Article discusses the statutory explication of the duties of loyalty and care – and the standards by which discharge of such duties is judged – and authorities that bear upon whether, and (if so) in what sense, directors may owe a "duty of obedience" at some level.

1. In General.

A director must discharge his or her duties (1) in good faith, (2) with ordinary care, and (3) in a manner that the director reasonably believes to be in the best interest of the corporation. TEX. BUS. ORGS. CODE § 22.221(a). These standards apply to a director with respect to actions both on the governing board of the entity and on a committee. *See id*. Prong (2) essentially imposes the duty of care on directors, and prong (3) essentially imposes the duty of loyalty on directors. Prong (1)'s "good faith" may be conceptualized various ways; the author prefers to think of good faith as an element of both loyalty and care.

Prongs (2) and (3) are fairly straight-forward in principle, even if they articulate standards, compliance with which may be difficult to determine in some circumstances. "Ordinary care" means the care that an ordinarily prudent person in a similar position would exercise under similar circumstances. TEX. BUS. ORGS. CODE § 22.001(6). The requirement that a director act in a manner that the director reasonably believes to be in the corporation's best interest means that a director must put no other interest ahead of the corporation's interest, whether the competing interest is that of the director or that of a third person.

"Good faith" merits a bit more explanation. The official comment to section 8.30 of the Revised Model Nonprofit Corporation Act characterizes the requirement of good faith as a "precondition" to the discharge of duties as a director. It further states that a court "will look to the director's state of mind to see if it evidenced honesty and faithfulness to the director's duties and obligations." According to the American Law Institute's PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS (Tentative Draft no. 1, March 19, 2007) (hereinafter "PLNO"), the requirement of good faith is a component of both the duty of care and the duty of loyalty. *See id.* § 300, cmt. g(1). A failure to act in good faith includes conscious disregard of the charitable organization's best interests, "including intentionally abdicating the duty of care." *Id.* Good faith is also said to include the obligation of a director "to disclose to other board members nonconfidential material information that they do not already possess." *Id.* § 300, cmt. g(2).

2. Statutory Negation of Duties as Equivalent to those of a Trustee.

By statute, a director of a Texas nonprofit corporation is not considered to have the duties of a trustee of a trust, with respect to either the corporation or property held or administered by the corporation, including property subject to donor-imposed restrictions. TEX. BUS. ORGS. CODE § 22.223. This provision tracks the language of Section 8.30(e) of the Revised Model Nonprofit Corporation Act.

One should interpret this provision with care and caution. The statutory language does not appear to foreclose imposing on a nonprofit corporation – the entity itself (as distinguished from the entity's directors) – the duties of a trustee when the corporate entity serves as trustee of an express charitable trust.

3. Reliance on Other Persons.

a. Reliance on Others with Special Expertise or Knowledge: In General.

In discharging a duty or exercising a power, a member of the board of directors generally may rely on information, opinions, reports, or statements (including financial statements and other financial data) prepared or presented by (1) an officer or employee of the entity; (2) legal counsel; (3) a certified public accountant; (4) an investment banker; (5) a person who the director reasonably believes possesses professional expertise in the matter; or (6) a committee of the board of which the director is not a member. TEX. BUS. ORGS. CODE § 3.102(a). Such reliance is not always justified, however. A member of the board of directors may rely upon the foregoing information only if the director has done so in good faith and with ordinary care. TEX. BUS. ORGS. CODE § 3.102(a). Reliance is not in good faith if the director has knowledge of a matter that makes her reliance unwarranted. TEX. BUS. ORGS. CODE § 3.102(b).

b. Delegation of Investment Authority.

The board of directors of a corporation may, by contracting with an investment advisor, trust company, bank, or investment manager (an "advisor"), confer on the advisor the authority to purchase or otherwise acquire an investment on behalf of the corporation, and to sell, transfer, or otherwise dispose of an asset at a time and for a consideration that the advisor considers appropriate. TEX. BUS. ORGS. CODE § 22.224(a). Similarly, the board of directors may remove or replace the advisor, with or without cause, if the board considers that action appropriate or necessary. TEX. BUS. ORGS. CODE § 22.224(c).

The board of directors may also (1) confer on an advisor other powers regarding the corporation's investments as the board considers appropriate; and (2) authorize the advisor to hold title to property of the corporation, in the name of the advisor or a nominee, for the benefit of the corporation. TEX. BUS. ORGS. CODE § 22.224(b).

If the board acted in good faith and with ordinary care in selecting the advisor, directors are not liable for the advisor's actions (and failures to act). TEX. BUS. ORGS. CODE § 22.224(c).

4. Transactions Involving a Conflict of Interest.

a. In General.

Certain transactions entered into by a Texas nonprofit corporation are suspect because directors or related parties are financially interested in the transactions. These transactions are subject to special rules. The special rules apply to a contract or transaction between the following: (1) a nonprofit corporation and one or more of the nonprofit corporation's directors, officers, or members, or associates or affiliates of the foregoing; or (2) a nonprofit corporation and an entity or other organization in which one or more of the nonprofit corporation's directors, officers, or members, or associates or affiliates of the foregoing, is a managerial official or a member, or in which the same has a financial interest. TEX. BUS. ORGS. CODE § 22.230(a). This Article refers to any such contract or transaction as a "conflict-of-interest" transaction.

b. Validity of Conflict-of-Interest Transactions.

An otherwise valid, enforceable conflict-of-interest transaction is still valid and enforceable notwithstanding the presence of the financial interest or relationship described above <u>if any one of the following three conditions is present</u>:

> **1)** The material facts as to the relationship or interest, and as to the conflict-of-interest transaction, are disclosed to or known by the board of directors, a committee of the board, or the corporation's members, and the board, the committee, or the members in good faith and with ordinary care authorize the conflict-of-interest transaction by the affirmative vote of the majority of the disinterested directors, committee members or members, regardless of whether the disinterested directors, committee members or members constitute a quorum. TEX. BUS. ORGS. CODE § 22.230(b)(1)(A).
>
> **2)** The material facts as to the relationship or interest, and as to the conflict-of-interest transaction, are disclosed to or known by the members entitled to vote on the authorization of the conflict-of-interest transaction, and the conflict-of-interest transaction is specifically approved in good faith and with ordinary care by a vote of the members. TEX. BUS. ORGS. CODE § 22.230(b)(1)(B).
>
> **3)** The conflict-of-interest transaction is fair to the corporation when it is authorized, approved, or ratified by the board of directors, a committee of the board, or the corporation's members. TEX. BUS. ORGS. CODE § 22.230(b)(2).

Common or interested directors or members of a nonprofit corporation may be included in determining the presence of a quorum at a meeting of the board, a committee of the board, or members that authorize the conflict-of-interest transaction. TEX. BUS. ORGS. CODE § 22.230(c).

c. Effect on Directors' Liability.

If at least one of the three conditions set forth in II.A.4.b, above, is satisfied, the corporation will have no cause of action against any of the persons described above for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described above or took any of certain actions authorized by the statute. TEX. BUS. ORGS. CODE § 22.230(e). Such actions include (1) participating in and, if the person is a director, member, or committee member, voting at a meeting of the board of directors, of members, or of a committee of the board (respectively) that authorizes the contract or transaction; and (2) signing, in the person's capacity as a director, member, or committee member, a written consent of the directors, members, or committee members (respectively) to authorize the contract or transaction. TEX. BUS. ORGS. CODE § 22.230(d).

d. Absolute Prohibition of Certain Loans.

Notwithstanding these general rules governing a conflict-of-interest transaction, a nonprofit corporation may not make a loan to a director. TEX. BUS. ORGS. CODE § 22.225(a). The directors who vote for or assent to the making of a loan to a director, and any officer who participates in making the loan, are jointly and severally liable to the corporation for the amount of the loan until it is repaid. TEX. BUS. ORGS. CODE § 22.225(b).

5. Distributions in Context of Insolvency or Liquidation.

a. General Liability for Distributions in Context of Insolvency or Liquidation.

In addition to any other liability imposed by law on the directors of a nonprofit corporation, the directors who vote for or assent to a distribution of assets (other than in payment of the corporation's debts), when the corporation is insolvent or when distribution would cause the corporation to be insolvent, or during the liquidation of the corporation, without the payment and discharge of, or making adequate provisions for, any known obligation of the corporation, are jointly and severally liable to the corporation for the value of the assets distributed, to the extent that the known obligation is not paid and discharged. TEX. BUS. ORGS. CODE § 22.226(a).

b. Exceptions.

1) Justifiable Reliance on Others.

A director is not liable if, in voting for or assenting to a distribution, the director relied in good faith and with ordinary care on information or an opinion, report, or statement in accordance with Section 3.102 of the TBOC, discussed *supra*. TEX. BUS. ORGS. CODE § 22.226(b)(1).

2) Good Faith and Ordinary Care Assessment.

A director is not liable if, in voting for or assenting to a distribution, the director, acting in good faith and with ordinary care, considered the assets of the corporation to be at least equal to their book value. TEX. BUS. ORGS. CODE § 22.226(b)(2).

3) Reliance on Third-Party Financial Information.

A director is not liable if, in voting for or assenting to a distribution, the director, in determining whether the corporation made adequate provision for the discharge of all of its obligations, relied in good faith and with ordinary care on financial statements of, or other information concerning, a person who was or became contractually obligated to discharge some or all of those liabilities or obligations. TEX. BUS. ORGS. CODE § 22.226(b)(3).

4) Verified Dissent.

A director who is present at a meeting of the board of directors at which an unlawful distribution of assets in the context of insolvency or liquidation occurs is presumed to have assented to the action unless (1) the director's dissent has been entered in the minutes of the meeting; (2) the director has filed a written dissent to the action with the person acting as the secretary of the meeting before the meeting is adjourned; or (3) the director has sent a written dissent by registered mail to the secretary of the corporation immediately after the meeting has been adjourned. TEX. BUS. ORGS. CODE § 22.227(a). Thus, a director can avoid liability by dissenting to the distribution and properly verifying that dissent. However, the right to dissent under this section does not apply to a director who voted in favor of the action. TEX. BUS. ORGS. CODE § 22.227(b).

5) Reliance on Legal Counsel.

A director is not liable for an unlawful distribution in the context of insolvency or liquidation if, in the exercise of ordinary care, the director acted in good faith and in reliance on the written opinion of an attorney for the corporation. TEX. BUS. ORGS. CODE § 22.228.

c. Right to Contribution.

A director against whom a claim is asserted in connection with an unlawful distribution in the context of insolvency or liquidation and who is held liable on the claim is entitled to contribution from persons who accepted or received the distribution knowing the distribution to have been made in violation of that section, in proportion to the amounts received by those persons. TEX. BUS. ORGS. CODE § 22.229.

6. Duties Associated with "Obedience" Norms.

a. Introduction to the (Disputed) Duty of Obedience.

Some courts and commentators state that a director owes a "duty of obedience" to the corporation. For example, in *Manhattan Eye, Ear and Throat Hosp. v. Spitzer*, 186 Misc. 2d 126, 152 (N.Y. Sup. Ct. 1999), the Supreme Court of New York County regarded as "axiomatic" the proposition that "the board of directors is charged with the duty to ensure that the mission of the charitable corporation is carried out." The court identified this duty as the "duty of obedience," and characterized it as requiring a director of a nonprofit corporation to "be faithful to the purposes and goals of the organization." *Id.*

In contrast, PLNO expressly declines to recognize a distinct "duty of obedience" and certain limitations on fiduciary behavior that the duty is understood to entail. *See* PLNO, § 300 cmt. g(3).

There is Texas case law specifically identifying the duty of obedience as such in the context of for-profit corporations, but the duty's substantive content is apparently limited to prohibiting acts contrary to charter provisions. *See, e.g., Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5^{th} Cir. 1984).

Whether or not one recognizes a "duty of obedience" as such, an important task is to decide exactly what directors of a nonprofit corporation must "obey," under whatever duty (e.g., care or loyalty, exercised in good faith) they may fall. Parts II.A.6.b.1. & 2 briefly describe what the law generally requires corporate directors to obey. Parts II.A.6.c and following discuss a host of specific issues surrounding these general obedience norms.

b. What Must a Director Clearly "Obey" in General?

In general terms, it is clear that a director must cause her corporation to obey (1) the law; and (2) the corporation's governing instrument (e.g., its certificate of formation, or "charter").

1) Obedience to Law.

Nonprofit corporations, like other entities, are typically required to act in accordance with the law. *See, e.g.*, TEX. BUS. ORGS. CODE § 2.003(1)(A) (stating that a domestic entity may not engage in an "activity that is expressly unlawful or prohibited by a law of this state"). Fiduciaries who deliberately cause the entity to act unlawfully would presumably breach their statutory fiduciary duties. *Cf.* TEX. BUS. ORGS. CODE § 2.113(a) (stating that the statutory section specifying a domestic entity's powers "does not authorize ... a managerial official of a domestic entity to exercise a power in a manner inconsistent with a limitation on the purposes or powers of the entity contained in ... this code, or other law of this state"); *In re Walt Disney Co.*, 906 A.2d 27, 67 (Del. 2006) ("A failure to act in good faith may be shown ... where the fiduciary acts with the intent to violate applicable positive law....").

2) Obedience to Charter.

Directors of a nonprofit charitable corporation must not cause the entity to act contrary to its corporate purposes. *Cf*. TEX. BUS. ORGS. CODE § 2.113(a) (stating that the statutory section specifying a domestic entity's powers "does not authorize ... a managerial official of a domestic entity to exercise a power in a manner inconsistent with a limitation on the purposes or powers of the entity contained in its governing documents"). The Texas Attorney General may sue to enjoin any such action, and a corporation may sue a director who causes a corporation to act outside of its corporate purposes. *See* TEX. BUS. ORGS. CODE § 20.002(c)(2), (c)(3)(B). A positive duty imposed on directors to advance the charitable purposes of the corporations that they oversee has also been recognized. *See, e.g., Oberly v. Kirby*, 592 A.2d 445, 469 n. 17 (Del. 1991) (referring to "the special duty of the fiduciaries of a charitable corporation to protect and advance its charitable purpose"); *id.* at 472-73 (stating that the fiduciaries of a charitable corporation "have a special duty to advance its charitable goals").

c. Obedience and the Power to Amend Certificate of Formation.

TBOC section 3.051 authorizes a Texas nonprofit corporation to amend its certificate of formation. The question naturally arises, does the duty to obey charter terms preclude directors of a charitable corporation from amending its historic purposes stated in its certificate of formation? The better view is that the answer is "no." *See, e.g., City of Hughes Springs v. Hughes Springs Volunteer Ambulance Serv.*, 223 S.W.3d 707, 710, 713-16 (Tex. App. 2007); *Attorney General v. Hahnemann Hosp.*, 397 Mass. 820, 834 (1986).

d. Obedience and the Power of Directors to Employ Pre-Amendment Donations to Further Amended Purposes or to Make Liquidating Distributions to Dissimilar Donees.

1) Introducing the Issue.

An issue that is not easily resolved is whether a charity may use assets held prior to a charter amendment—and assets received as substitutes or replacements for such pre-amendment assets—to further post-amendment purposes. A similar issue is whether a charity desiring to terminate its existence may, pursuant to a plan of dissolution, transfer its assets to a charity having purposes dissimilar to those expressed in its charter.[1] In either case, this Article will refer to a requirement that directors use assets to further the *historic charter purposes* of the charity in question as the "static charter fidelity norm."

2) Authorities Supporting Static Charter Fidelity Norm.

Some authorities have imposed the static charter fidelity norm on directors. *See, e.g., In re Manhattan Eye, Ear & Throat Hospital v. Spitzer*, 186 Misc. 2d 126, 715 N.Y.S.2d 575 (N.Y. Supp. Ct. 1999); *Attorney General v. Hahnemann Hospital*, 494 N.E. 2d 1011 (Mass. 1986); *Queen of Angels Hospital v. Younger*, 136 Cal. Rptr. 36 (Cal. Ct. App. 1977); *Banner Health Sys. v. Long*, 663 N.W.2d 242 (S.D. 2003)

In Texas, the leading authority is is *Blocker v. State*, 718 S.W.2d 409 (Tex. Ct. App. – Houston [1st dist.] 1986), writ ref'd n.r.e. In *Blocker v. State,* the court held that the directors of a charitable corporation had breached their fiduciary duties by attempting to distribute corporate assets in dissolution to a private estate in which several directors had a beneficial interest. Although the holding itself is unremarkable, its rationale is potentially far-reaching. The language is sufficiently sweeping to reach contexts not involving dissolution of the corporation. The court held that property transferred to a charitable corporation is "subject to implicit charitable or educational limitations *defined by the donee's organizational purpose* and within the meaning of the statute, where no express limitation to the contrary is stated in the transfer." *Id.* at 415. According to the court, property that can be traced to such assets was likewise held by the charity "*subject to the limitations imposed on the corporation by the terms of its own articles of incorporation*." *Id.* (emphasis added); *see also id.* ("We hold that the real property and personalty were assets received and held by the corporation, whether from donation or purchase, subject to limitations permitting their use only for educational purposes, *by reference to the stated purposes set forth in the articles of incorporation*.") (emphasis in original). The court agreed with the state's argument that "by their very incorporation for purely charitable and benevolent purposes [charitable corporations] have made a contract with the State and with the beneficiaries named in the charters effectually constituting those in charge of the enterprise *trustees of an express trust, and their charters in their last analysis and in their legal effect become declarations of trust*." *Id.* at 416. Having reasoned that the assets of a charitable corporation are held in trust, the court then construed the statutory dissolution provision of then-existing law, which expressly required distributions in dissolution to transferees having purposes similar to those of the dissolving entity in the case of "[a]ssets received and held by the corporation subject to limitations permitting their use only for charitable, religious, eleemosynary, benevolent, educational or similar purposes." The court held that a non-profit corporation's acceptance of donations triggered this statutory provision under the theory that the terms of the donee's corporate charter rendered donations restricted charitable gifts. *See id.* at 415-16.

3) Authorities Rejecting Static Charter Fidelity Norm.

Not all authorities have imposed the static charter fidelity norm on directors. For example, PLNO provides that, if charter purposes are amended, general, unrestricted funds held by the charity may be used to advance post-amendment purposes. PLNO § 245 (preliminary draft). *See also Kans. E. Conference of the United Methodist Church, Inc. v. Bethany Medical Center, Inc.*, 969 P.2d 859 (Kan. 1998); *Dodge v. Trustees of Randolph-Macon Woman's College*, 661 S.E.2d 805 (Va. 2008).

In Texas, the most interesting case is *City of Hughes Springs v. Hughes Springs Volunteer Ambulance Serv.*, 223 S.W.3d 707, 710, 713-16 (Tex. App.—Texarkana 2007). In this case, a nonprofit corporation originally formed to operate an ambulance service was essentially foreclosed from performing its primary historical purpose by the actions of local government. Following these events, the nonprofit corporation amended its charter purposes so as "to provide various services to the community which relate to the health and safety of the citizens in the Hughes Springs area." A member of the nonprofit corporation petitioned the court to dissolve and liquidate the entity. She relied on a provision of the Texas Nonprofit Corporation Act, TEX. REV. CIV. STAT. ANN. art. 1396-7.06 (Vernon 2003), which required a court to find, in relevant part, that "the corporation is unable to carry out its purposes." In relevant part, the court held that the amendments to the nonprofit's articles of incorporation were valid. *See Hughes Springs*, 223 S.W.3d 707, 714-15. In view of the propriety of the amended charter purposes, the member of the nonprofit corporation could not bring a petition to force liquidation of the entity under the statutory provision that conditioned such liquidation on a determination that "the corporation is unable to carry out its purposes." *See id.* at 716. The court reasoned that the statute did not apply, because the nonprofit "is able to carry out its purpose as amended." *See id.* The court further opined that "[t]he doctrine of *cy pres* does not prohibit the [corporation] from amending its purpose or require [it] to be dissolved." *Id.* at 716.

e. Obedience and Change in Mission.

There is little precedent directly and clearly articulating whether, and, if so, in what sense, directors of a nonprofit corporation have a duty to advance the corporation's mission. Two issues are relevant.

1) Obedience to Historic Mission?

One issue is whether the directors of a nonprofit charitable corporation (1) may, in the good faith exercise of prudence, change the corporation's mission and use its assets to further the new mission when the mission change requires no amendment to the corporate charter, or instead (2) must further the corporation's historic mission in the absence of judicial approval of a mission change. We may refer to a requirement that binds directors to a corporation's historic mission (absent judicially approved deviation) as the historic mission fidelity norm. A few authorities embracing the static charter fidelity norm also seem to support the historic mission fidelity norm. *See, e.g., In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999); *Queen of Angels*, 136 Cal. Rptr. 36, 40-41 (Cal. Ct. App. 1977). However, it is far from clear that these cases support recognition of the historic mission fidelity norm independently of the static charter fidelity norm. Cases that reject the static charter fidelity norm, *see. e.g., City of Hughes Springs v. Hughes Springs Volunteer Ambulance Serv.*, 223 S.W.3d 707, 710, 713-16 (Tex. App. 2007), likewise do not support adoption of the historic mission fidelity norm.

2) Obedience to Mission, as the Same May Be Modified over Time?

Let us assume that the Texas Supreme Court would hold that the directors of a nonprofit charitable corporation may, in the exercise of good faith and prudence, modify the corporation's mission and use all corporate assets to further the new mission. Another question is still relevant: Do the directors of a nonprofit corporation have an affirmative duty to advance the corporation's mission, as it may be amended from time to time? Although such a requirement finds some support among legal commentators, *see, e.g.*, Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 904-05 (2007), there is little binding legal authority on point. One could argue that requiring directors to govern so as to further the entity's mission is sensibly viewed as an element of good faith, provided that "mission" is not defined statically. At a minimum, requiring directors to carry out a charity's mission, as the same may be amended from time to time, focuses managers' attention on mission and thereby promotes good governance.

f. Additional References on Obedience Norms.

For additional discussion of obedience norms, see Johnny Rex Buckles, *How Deep Are the Springs of Obedience Norms that Bind the Overseers of Charities?*; _____ CATH. UNIV. L. REV. ____ (2013) (forthcoming); Johnny Rex Buckles, *Nonprofit Directors and Obedience*, presented at the Governance of Nonprofit Organizations Course (sponsored by the State Bar of Texas) (August 24, 2012).

B. Special Situation: Investment and Management of Funds.

The general standards of care (and, to some degree, standards governing the duty of obedience) governing directors of a nonprofit, charitable corporation give way to the more specific standards applicable to the management and investment of an "institutional fund" subject to TUPMIFA. Section IV of this Article presents an overview of TUPMIFA.

C. Limiting Liability for Actions as Director.

1. Limiting Liability under the Certificate of Formation: In General.

The certificate of formation of a Texas nonprofit corporation may provide that a director is not liable to the organization or its members, or is liable thereto only to the extent provided by the certificate of formation, for monetary damages for an act or omission by the person in his or her capacity as a director. TEX. BUS. ORGS. CODE § 7.001(b).

2. Exceptions.

The general rule authorizing the limitation of a director's liability does not authorize the elimination or limitation of the liability of a director to the extent that he or she is found liable under applicable law for any of the following: (1) a breach of the duty of loyalty to the corporation or its members; (2) an act or omission not in good faith that constitutes a breach of duty to the corporation; (3) an act or omission not in good faith that involves intentional misconduct or a knowing violation of law; (4) a transaction from which the director received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the director's duties; or 5) an act or omission for which the liability of a director is expressly provided by an applicable statute. TEX. BUS. ORGS. CODE § 7.001(c).

III. FIDUCIARY DUTIES GOVERNING TRUSTEES OF A CHARITABLE TRUST.

A. Introduction to the Duties of a Trustee of a Trust.

1. In General.

A trustee must administer a trust in good faith and according to its terms. TEX. PROP. CODE § 113.051. Unless the trust instrument or the TTC states to the contrary, in administering the trust the trustee must perform all of the duties imposed on trustees by the common law. *Id.*

2. Applicability of the Texas Trust Code to Charitable Trusts: In General.

The terms and structure of the TTC make clear that the statute generally applies to charitable trusts. *See, e.g.*, TEX. PROP. CODE § 111.006 (stating that the TTC applies to all trusts created on or after January 1, 1984, and generally applies to all transactions occurring on or after January 1, 1984, relating to trusts created before January 1, 1984); TEX. PROP. CODE § 112.055 (imputing terms of trust governing "a trust that is a private foundation" as defined in Code section 509(a) so as to prohibit the trustee from acting in a way that triggers the private foundation excise taxes under the Code); TEX. PROP. CODE § 112.056 (permitting the written amendment of an instrument governing a private foundation to expressly include or exclude the provisions required by TEX. PROP. CODE § 112.055(a) if the settlor of the trust is living and competent and consents to the amendment); TEX. PROP. CODE § 113.0211 (permitting a trustee of certain types of charitable trust to manage investments under the prudent investor rule and to make certain adjustments between the principal and the income portions of a trust). Thus, specific fiduciary standards set forth in the TTC generally apply to the trustees of a charitable trust.

3. Applicability of the Texas Trust Code to Charitable Trusts: Effect of TUPMIFA.

a. Trusts to which TUPMIFA Does not Apply.

TUPMIFA generally defines an "institutional fund" (the management of which is governed by the standards of prudence set forth in TUPMIFA) as "a fund held by an institution exclusively for charitable purposes." TEX. PROP. CODE § 163.003(5). An "institution" includes a charitable trust and a charitable corporation. TEX. PROP. CODE § 163.003(4)(A) & (6). However, TUPMIFA excepts from the definition of "institutional fund" a "fund held for an institution by a trustee that is not an institution." TEX. PROP. CODE § 163.003(5)(B). Thus, charitable trusts of which individuals or for-profit corporations (such as bank and trust companies) are trustees are not subject to TUPMIFA, but a charitable trust of which another charity is trustee is governed by TUPMIFA. This construction of the statute is confirmed by the National Conference of Commissioners on Uniform State Laws' Prefatory Note and Comments to Section 2, Subsections 4, 5, and 6 accompanying their adoption of the Uniform Prudent Management of Institutional Funds Act. Thus, the TTC comprehensively governs charitable trusts that have individuals or for-profit corporate fiduciaries as trustees.

b. Trusts to which TUPMIFA Does Apply.

Section 163.011 of TUPMIFA states that the Texas Trust Code "does not apply to any institutional fund subject to this chapter." However, section 163.004(b) of TUPMIFA requires managers to comply with the general prudent investment standard of TUPMIFA "in addition to complying with the duty of loyalty imposed by law other than this chapter." Thus, TUPMIFA is best construed to supplant the provisions of the TTC that otherwise would govern standards of prudent investment and management of a "fund" held by a charitable trust of which a charitable entity is the trustee, but not the provisions of the TTC that do not pertain to prudent investment.

B. Duty of Loyalty.

1. In General.

A trustee must invest and manage trust assets solely in the interest of the beneficiaries. TEX. PROP. CODE § 117.007. The duty of loyalty "is general in its use and is fundamental." *Slay v. Burnett Trust*, 187 S.W. 2d 377, 387 (Tex. 1945). It prohibits a trustee "from using the advantage of his position to gain any benefit for himself at the expense of his cestui que trust and from placing himself in any position where his self interest will or may conflict with his obligations as trustee." *Id.* at 388. There are numerous provisions of the TTC, discussed in this Article, that apply this duty of loyalty in specific circumstances. These specific provisions do not, however, exhaust the contexts in which a trustee owes a duty of loyalty.

2. Impartiality.

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing trust assets, taking into account any differing interests of the beneficiaries. TEX. PROP. CODE § 117.008.

3. Loan of Trust Funds.

Generally, a trustee may not lend trust funds to: (1) the trustee or an affiliate; (2) a director, officer, or employee of the trustee or an affiliate; (3) a relative of the trustee; or (4) the trustee's employer, employee, partner, or other business associate. TEX. PROP. CODE § 113.052(a). However, the following are permitted: (1) a loan by a trustee to a beneficiary of the trust if the loan is expressly authorized or directed by the instrument or transaction establishing the trust; and (2) a deposit by a corporate trustee with itself under TTC section 113.057. TEX. PROP. CODE § 113.052(b).

4. Purchase and Sales of Trust Assets.

A trustee may not directly or indirectly buy or sell trust property from or to: (1) the trustee or an affiliate; (2) a director, officer, or employee of the trustee or an affiliate; (3) a relative of the trustee; or (4) the trustee's employer, partner, or other business associate. The statute provides limited exceptions, primarily applicable to fiduciaries that are bank and trust companies. *See* TEX. PROP. CODE § 113.053.

5. Sale from One Trust to another Trust.

A trustee of one trust may not sell property to another trust of which it is also trustee unless the property is: (1) a bond, note, bill, or other obligation issued or fully guaranteed as to principal and interest by the United States; and (2) sold for its current market price. TEX. PROP. CODE § 113.054.

6. Purchase of Trustee's Securities or an Affiliate's Securities.

In general, a corporate trustee may not purchase for the trust the stock, bonds, obligations, or other securities of the trustee or an affiliate, and a noncorporate trustee may not purchase for the trust the stock, bonds, obligations, or other securities of a corporation with which the trustee is connected as director, owner, manager, or any other executive capacity. However, notwithstanding these rules, a trustee may: (1) generally retain stock already owned by the trust (unless the retention is imprudent); and (2) exercise stock rights or purchase fractional shares if permitted under TTC section 113.053. TEX. PROP. CODE § 113.055.

C. Duty of Prudent Investment.

Because TUPMIFA does not apply to a charitable trust managed by individual trustees or for-profit corporate trustees, standards of prudent investment governing those trustees appear in the TTC, not TUPMIFA. For such trustees, compliance with the TTC is imperative. <u>This portion of the Article focuses on the standards of prudent investment set forth in the TTC.</u>

1. The Prudent Investor Rule.

A trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee must exercise reasonable care, skill, and caution. TEX. PROP. CODE § 117.004(a). In general, a trustee may invest in any kind of property or type of investment consistent with these standards. TEX. PROP. CODE § 117.004(e).

2. Applicability of the Prudent Investor Rule.

Generally, a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule. TEX. PROP. CODE § 117.003(a). However, the prudent investor rule is a default rule, and as such may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust. TEX. PROP. CODE § 117.003(b).

3. Context for Applying the Prudent Investor Rule.

A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. TEX. PROP. CODE § 117.004(b).

4. General Factors to Consider under the Prudent Investor Rule.

Among circumstances that a trustee must consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries. TEX. PROP. CODE § 117.004(c).

5. Duty to Diversify.

A trustee must diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. TEX. PROP. CODE § 117.005.

6. Duty with Respect to Initial Trust Assets.

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee must review the trust assets and make decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of the prudent investor rule. TEX. PROP. CODE § 117.006.

7. Trustee with Special Expertise.

A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise. TEX. PROP. CODE § 117.004(f).

8. Judging Compliance with the Prudent Investor Rule.

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight. TEX. PROP. CODE § 117.010.

D. Duties with Respect to Delegation.

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1. In General.

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. TEX. PROP. CODE § 117.011(a).

2. Effect on Trustee's Liability.

A trustee who complies with the above requirements on delegation is not liable for the decisions or actions of the agent to whom the function was delegated, unless (1) the agent is an affiliate of the trustee; or (2) under the terms of the delegation, either (A) the trustee or a beneficiary of the trust is required to arbitrate disputes with the agent, or (B) the period for bringing an action by the trustee or a beneficiary of the trust with respect to an agent's actions is shortened from that which is applicable to trustees under state law. TEX. PROP. CODE § 117.011(c).

E. Duty to Obey Terms of Trust and Associated Exceptions.

As observed previously, under Texas law a trustee must administer a trust according to its terms. TEX. PROP. CODE § 113.051. Similarly, under the Restatement (Third) of Trusts, a trustee "has a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law." RESTATEMENT (THIRD) OF TRUSTS § 76(1) (2003). The official comments to this Restatement rule refer to the duty as the "normal duty of a trustee to obey the terms of the trust." *Id.* § 76(1) at cmt. b(1). The law of charitable trusts permits deviation from trust terms only in limited circumstances.

1. The Doctrine of Cy Pres.

Under the traditional doctrine of cy pres, a court may direct charity fiduciaries to apply charitable trust funds to purposes similar to the original trust purposes when accomplishing the original purposes becomes impossible, impracticable, or illegal, as long as the transferor of the funds has manifested an intent to devote the funds to charitable purposes more general than the frustrated specific charitable purpose. *See* RESTATEMENT (SECOND) OF TRUSTS § 399 (1959); *cf.* RONALD CHESTER, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 438 (3d ed. 2005) (stating that the doctrine applies when, in relevant part, furthering the charitable use intended by the donor "is or becomes impossible or impractical"); *id.* § 436 ("The courts that have applied judicial cy pres to a charitable trust have usually required that the settlor have exhibited a general or broad charitable intent in addition to the particular purpose served by that trust."); 6 AUSTIN W. SCOTT ET AL., 6 SCOTT AND ASCHER ON TRUSTS § 39.5.2 (2010) [hereinafter SCOTT AND ASCHER ON TRUSTS) (stating that a court may apply cy pres when it is "unlawful, impossible, impracticable, or wasteful" to carry out the settlor's particular charitable purposes).

Some sources articulate the doctrine as involving three prongs: (1) the settlor gratuitously transferred property in trust for a designated charitable purpose; (2) carrying out the designated purposes of the gift is, or becomes, impossible, impracticable, or illegal; and (3) the trustor manifested a general intention to devote the gifted property to charitable purposes. *See* 15 AM. JUR. 2D *Charities* § 149 (2002). *See generally* 6 SCOTT ET AL. § 39.5 (discussing the cy pres doctrine).

The Restatement (Third) of Trusts and the Uniform Trust Code alter the traditional common law doctrine of cy pres by adding wastefulness to the grounds for applying the doctrine and presuming that a donor possesses general charitable intent, but they otherwise follow the traditional doctrine of cy pres. *See* RESTATEMENT (THIRD) OF TRUSTS § 67 & cmt. b, *Reporter's Notes on § 67*, cmt. b (2003) (describing the modern rule as "displacing the traditional quest for a settlor's 'general charitable intent' when the trust" is silent); UNIF. TRUST CODE § 413 (2005).

2. The Doctrine of Equitable Deviation.

Closely related to the doctrine of cy pres is the doctrine of deviation (or "equitable deviation"). This latter doctrine empowers a court to direct a trustee of a charitable trust to deviate from the administrative terms of a trust if compliance with the original terms is impossible or illegal, or if compliance with the terms of trust would substantially impede the accomplishment of trust purposes on account of circumstances that the settlor did not foresee. *See* RESTATEMENT (THIRD) OF TRUSTS § 66(1) & cmt. c (2003) (expanding the doctrine to authorize deviation from terms that are not merely administrative); RESTATEMENT (SECOND) OF TRUSTS § 381 cmt. a (1959).

IV. OVERVIEW OF TUPMIFA.

A. Application of TUPMIFA.

As previously discussed, TUPMIFA generally applies to an "institution" that manages and invests "institutional funds" exclusively for charitable purposes. *See* TEX. PROP. CODE § 163.003(4). "Institutions" include nonprofit corporations, unincorporated associations, and other types of entities organized exclusively for charitable purposes, including private foundations described in Internal Revenue Code section 509(a). An "institutional fund" is generally defined as a "fund held by an institution exclusively for charitable purposes." TEX. PROP. CODE § 163.003(5). However, the term does not include "a fund held for an institution *by a trustee that is not an institution*." TEX. PROP. CODE § 163.003(5)(B) (emphasis added). Thus, as noted previously, although TUPMIFA potentially applies both to charitable corporations and to trusts for which a charitable organization serves as the trustee, it does not apply to charitable trusts with commercial or individual trustees. *See* TEX. PROP. CODE § 163.003(5)(B).

B. General Standard for Managing Institutional Funds.

A person responsible for managing and investing an institutional fund must "manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." TEX. PROP. CODE § 163.004(b). If not provided otherwise in a gift instrument, an institution must consider the following factors, if relevant, in managing and investing an institutional fund: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences, if any, of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall investment portfolio of the fund; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; (7) the needs of the institution and the fund to make distributions and to preserve capital; and (8) an asset's special relationship or special value, if any, to the charitable purposes of the institution. TEX. PROP. CODE § 163.004(e)(1).

C. Standards Governing Accumulations of, and Distributions from, an Endowment Fund.

Certain types of institutional funds – endowment funds – are subject to special rules governing accumulation and distribution. TUPMIFA defines an "endowment fund" as "an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis." TEX. PROP. CODE § 163.003(2). However, an endowment fund "does not include assets that an institution designates as an endowment fund for its own use." *Id.*

1. General Standard of Prudence.

In general, and subject to "the intent of a donor expressed in the gift instrument" and special rules setting forth rebuttable presumptions of imprudence, TUPMIFA provides that "an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established." TEX. PROP. CODE § 163.005(a). TUPMIFA further states that, "in making a determination to appropriate or accumulate, the institution shall act in good faith, [and] with the care that an ordinarily prudent person in a like position would exercise under similar circumstances." *Id.*

2. Factors Bearing on Prudence.

TUPMIFA states that, in making a determination to appropriate or accumulate, the institution "shall consider, if relevant, the following factors": (1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund; (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and (7) the investment policy of the institution. TEX. PROP. CODE § 163.005(a).

3. Rebuttable Presumptions of Imprudence.

a. In General.

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TUPMIFA sets forth a rebuttable presumption of imprudence that varies generally by endowment size, and that applies differently to extremely large university endowments. Generally, TUPMIFA classifies endowment funds into two categories—those with aggregate values of $1,000,000 or greater and those with aggregate values of less than $1,000,000.

- For endowment funds with a value of at least $1,000,000, an appropriation for expenditure of an amount greater than seven percent of the fair market value of an endowment fund—determined at least quarterly and averaged over a three year period—is presumed imprudent, but the presumption is rebuttable. *See* TEX. PROP. CODE § 163.005(d).

- For endowment funds valued at less than $1,000,000, TUPMIFA creates a rebuttable presumption of imprudence if more than five percent of the fair market value of the fund is appropriated for expenditure in one year. *See* TEX. PROP. CODE § 163.005(e). The rules regarding this presumption are the same as those for endowment funds valued at greater than $1,000,000, except for the smaller five percent threshold.

b. Special Rule for University Mega-Endowments.

Under TUPMIFA, the general seven percent rule does not apply to university system endowment funds valued at $450,000,000 or more. For these funds, the presumption of imprudence arises if an amount greater than nine percent of the fair market value of an endowment fund is appropriated for expenditure in one year. *See* TEX. PROP. CODE § 163.005(f).

D. Modifications of Donor Restrictions on Funds.

Donor restrictions on institutional funds raise obvious "obedience" questions. TUPMIFA sets forth specific rules for modifying donor restrictions.

1. Modification through Donor Consent.

Under TUPMIFA, an institution may release or modify a restriction if the donor consents in a tangible or electronic writing, provided that the fund continues to be used for a charitable purpose. *See* TEX. PROP. CODE § 163.007(a).

2. Modification through Court Action.

a. Modifying Restrictions on Fund Investing.

An institution may apply to a court for the modification of a restriction regarding the management or investment of an institutional fund if any of the following are true: (1) the restriction has become impracticable or wasteful; (2) the restriction impairs the management or investment of the fund; or (3) a modification will further the purposes of the fund due to circumstances not anticipated by the donor. *See* TEX. PROP. CODE § 163.007(b). Requests for modification by a court require notification of the Office of the Texas Attorney General in accordance with Chapter 123 of the Texas Property Code. *See id.*; TEX. PROP. CODE § 123.003.

b. Modifying Restrictions on Fund Uses and Purposes.

A court may also modify the purpose of a fund or a restriction on the use of a fund if the purpose or restriction has become unlawful, impracticable, impossible to achieve, or wasteful. *See* TEX. PROP. CODE § 163.007(c). Any such modification must be consistent with the charitable purposes expressed in the gift instrument. *See id.* Requests for modification by a court require notification of the Office of the Texas Attorney General in accordance with Chapter 123 of the Texas Property Code. *See id.*; TEX. PROP. CODE § 123.003.

3. Special Rule for Small, Long-Held Funds.

An institution may release or modify a restriction without donor or court consent if the restriction is unlawful, impracticable, impossible to achieve, or wasteful, and all of the following are satisfied: (1) the institutional fund in question has a total value of less than $25,000; (2) more than twenty years have passed since the establishment of the fund; and (3) the institution uses the property in a manner that is consistent with the charitable purposes expressed in the gift instrument. *See* TEX. PROP. CODE § 163.007(d). An institution wishing to modify or release a restriction by its own authority may not act until sixty days after the attorney general receives notice of the intended action accompanied by a copy of the gift instrument and a statement of the facts. *See id.*

E. Additional Analysis of UPMIFA.

For a more advanced discussion of the issues raised by UPMIFA, see Johnny Rex Buckles, *Probing UPMIFA: The Mysteries of the Uniform Act in Light of Federal Tax and State Charity Laws and Concepts*, 46 REAL PROP. TR. & EST. L. J. 281 (2011).

V. PROFESSIONAL RESPONSIBILITY ISSUES.

A. First Principles: Identifying the Client.

1. Organization as Client.

Under the Texas Disciplinary Rules of Professional Conduct ("TDRPC"), an attorney "employed or retained by an organization represents the entity." TDRPC § 1.12(a). The organization is distinguishable from its "constituents," *see, e.g., id.,* which include an organization's "directors, officers, employees, members, shareholders." *See, e.g.,* TDRP §11.12(e). *See also* TDRPC § 1.12 cmt. 1 ("A lawyer employed or retained to represent an organization represents the organization as distinct from its directors, officers, employees, members, shareholders or other constituents."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §96 cmt. b (2000) ("A lawyer who has been employed or retained to represent an organization as a client owes professional duties of loyalty and competence to the organization. By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals employed by it or who direct its operations or who have an ownership or other beneficial interest in it ….").

2. Directors and Trustees as Representatives of Client.

Of course, charities must act through charity fiduciaries (e.g., directors, trustees and officers). *See* TDRPC § 1.12 cmt. 1 ("Unlike individual clients who can speak and decide finally and authoritatively for themselves, an organization can speak and decide only through its agents or constituents such as its officers or employees."). Consequently, "the lawyer-client relationship must be maintained through a constituent who acts as an intermediary between the organizational client and the lawyer." *Id.* Directors, trustees and officers, acting in a representative capacity, are thus those through whom the lawyer typically advises the organizational client.

B. Issues Arising from the Dual Capacity of Charity Fiduciaries: In General.

When an attorney is contacted by a charity fiduciary (e.g., a director or officer), the lawyer must be sensitive to the multiple capacities in which the fiduciary can act. A lawyer who has long represented a charity may be asked a legal question by a member of the charity's board of directors, for example, that raises issues not only for the charity, but also for the fiduciary personally.

1. Advice to Fiduciaries as Advice to Client.

When a director, trustee or officer of the client seeks legal counsel as to how it should act on behalf of the client, the representative is normally seeking legal advice on behalf of the client. When the attorney advises the representative in such circumstances, he or she is advising the organizational client. In many circumstances, when a director, trustee or officer seeks legal advice as to whether a proposed action is consistent with her fiduciary duties, often the legal advice is properly viewed as having been given to the organization. This conclusion follows from the premises that (1) an entity must act through its agents, including the fiduciaries who manage it; and (2) to properly discharge one's fiduciary duties is to act on behalf of the entity in the manner required by law.

Whether a charity fiduciary seeks legal advice primarily for herself, or instead for her charity, may not be clear, however. *The practical implication is obvious: When in doubt, spell it out!* Consider the following:

> [A] lawyer's failure to clarify whom the lawyer represents in circumstances calling for such a

> result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer. Hence, the lawyer must clarify whom the lawyer intends to represent when the lawyer knows or reasonably should know that, contrary to the lawyer's own intention, a person, individually, or agents of an entity, on behalf of the entity, reasonably rely on the lawyer to provide legal services to that person or entity …. Such clarification may be required, for example, with respect to an officer of an entity client such as a corporation…. An implication that such a relationship exists is more likely to be found when the lawyer performs personal legal services for an individual as well or where the organization is small and characterized by extensive common ownership and management. But the lawyer does not enter into a client-lawyer relationship with a person associated with an organizational client solely because the person communicates with the lawyer on matters relevant to the organization that are also relevant to the personal situation of the person. In all events, the question is one of fact based on the reasonable and apparent expectations of the person or entity whose status as client is in question.

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 cmt. f. (2000).

2. Joint Representation.

Subject to TDRPC § 1.6, an attorney may represent both an organizational client and its constituents (such as a director). *See* TDRPC § 1.12 cmt. 5.

3. Adverse Interests.

An organizational client's interest may be or become adverse to the interests of a constituent. Under the TDRPC, a lawyer must explain to an organizational client's constituents, such as directors and officers, "the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing or when explanation appears reasonably necessary to avoid misunderstanding on their part." TDRPC §1.12(e). Commentary to the TDRPC provides the following expanded guidance in the case of adverse interests:

> [T]he lawyers should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care should be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged insofar as that individual is concerned. Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

TDRPC §1.12 cmt. 4.

C. When and How Lawyer Must Take Remedial Action on Behalf of Organizational Client.

1. Text and Illustration of Rule Requiring Remedial Action.

Under the TDRPC, a lawyer representing an organization must take reasonable remedial actions whenever the lawyer learns or knows that: (1) an officer, employee, or other person associated with the organization has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization; (2) the violation is likely to result in substantial injury to the organization; and (3) the violation is related to a matter within the scope of the lawyers representation of the organization. TDRPC § 1.12 (b).

A director's obvious, contemplated breach of the duty of loyalty would trigger this rule. Consider the following illustration set forth in the Restatement (Third) of the Law Governing Lawyers:

> Charity promotes medical research through tax-deductible contributions made to it. President as chief executive officer of Charity retained Lawyer to represent Charity as outside general counsel and has extensively communicated in confidence with Lawyer ona variety of matters concerning Charity. President asks Lawyer to draft documents by which Charity would make a gift of a new luxury automobile to a social friend of President. In that and all other work, Lawyer represents only Charity and not President as a client. Lawyer concludes that such a gift would cause financial harm to Charity in violation of President's legal duties to it. Lawyer may not draft the documents. If unable to dissuade President from effecting the gift, Lawyer must take action to protect the interests of Charity (see Subsection (2) & Comment *f*). Lawyer may, for example, communicate withmembers of Charity's board of directors in endeavoring to prevent the gift from being effectuated.

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §96 cmt. e, *Illus*. 1 (2000).

However, a lawyer should not substitute his own judgment for that of directors on prudential/business matters. Comment 6 to TDRPC section 1.12 cautions that an organizational client's constituents' decisions "ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful." Decisions about policy and operations, even risky ones, "are not as such in the lawyer's province." TDRPC §1.12 cmt. 6. But remedial measures must be taken "when the lawyer knows, in regard to a matter within the scope of the lawyer's responsibility, that the organization is likely to be substantially injured by the action of a constituent that is in violation of law or in violation of a legal obligation to the organization." *Id*.

2. Procedures to Remediate.

The TDRPC set forth the following pathway for remediating the actions of constituents of an organizational client:

> Except where prior disclosure to persons outside the organization is required by law or other Rules, a lawyer shall first attempt to resolve a violation by taking measures within the organization. In determining the internal procedures, actions or measures that are reasonably necessary in order to comply with paragraphs (a) and (b), a lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyers representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Such procedures, actions and measures may include, but are not limited to, the following: (1) asking reconsideration of the matter; (2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
> (3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

TDRPC §1.12(c).

D. Lawyer's Service on Client's Board of Directors.

There is no per se prohibition against service by legal counsel on a client's board of directors in Texas. However, the practice does create the potential for conflicts. Note that an attorney owes fiduciary duties to the client by virtue of legal representation, and that the attorney also owes fiduciary duties as a director. A comment to the TDRPC states as follows:

> A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director.

TDRPC § 1.06 cmt. 16.

E. Lawyer's Competence in Advising on Fiduciary Duties.

Many transactions about which an attorney's client may seek legal advice raise not only state law fiduciary duty issues, but also issues under federal tax laws governing charitable nonprofits and their managers. For example, Code sections 4941 and 4958 impose excise taxes on various types of conflict-of-interest transactions between certain types of charities and various types of charity insiders. Indeed, one may conceptualize many provisions of the Internal Revenue Code as federalizations of fiduciary duties. A lawyer advising charity fiduciaries of their duties to the client must be well versed in these tax laws in order to render complete advice. In this connection, observe that TDRPC 1.01(a) generally imposes a requirement that a lawyer represent a client only in matters within the lawyer's competence. According to the comments,

> A lawyer generally should not accept or continue employment in any area of the law in which the lawyer is not and will not be prepared to render competent legal services. Competence is defined in Terminology as possession of the legal knowledge, skill, and training reasonably necessary for the representation. Competent representation contemplates appropriate application by the lawyer of that legal knowledge, skill and training, reasonable thoroughness in the study and analysis of the law and facts, and reasonable attentiveness to the responsibilities owed to the client.

TDRPC § 1.01 cmt. 1.

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[1] Some state statutes require dissolving charities to distribute assets to organizations having charitable purposes similar to those of the dissolving entity. *See, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 1002-a(c)(1) (2011). Other statutes provide simply that the corporation must distribute its assets to other tax-exempt charities or governmental bodies (as Texas law now provides). *See, e.g.*, TEX. BUS. ORGS. CODE § 22.304(a)(2). If, as in Texas, the state statute does not literally require a dissolving entity to distribute assets only to a charitable transferee with specific purposes similar to those of the transferor, a court may be asked to decide whether to employ common law trust concepts to compel such a result.

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An Update on Innocent Spouse Claims

by
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I. ISSUES RELATED TO THE FILING OF RETURNS.

A. Joint Returns and Joint and Several Liability. The decision to file a joint return is one that must be carefully thought out during periods of separation and divorce or within a troubled marriage because of the joint and several liability issues in connection with the filing of a joint return.

B. Consider Filing Separately. Historically, the tax on married couples filing jointly generally has been lower than the combined tax on married couples filing separate returns. Now, however, in many cases, a married couple's tax will be the same whether they file jointly or separately. That's because (1) the end point of the 15% bracket for married couples filing jointly is now twice the end of the 15% bracket for a single filer or a married person filing separately, I.R.C. §1(f)(8)) and (2) the standard deduction for a married couple filing jointly is twice the standard deduction of a single person or a married person filing separately. I.R.C. §63(c)(2)). Thus, if there is a pending divorce or a spouse has questionable tax items, there may now be greater occasion to file separately than in the past because, in many cases, filing separately may no longer involve an increased tax cost or may only involve a slightly or moderately increased tax cost. However, joint filing may still produce a lower tax cost in many situations because there is still a marriage penalty for the income brackets above the 15% bracket and numerous tax breaks are unavailable[2] or less favorable on separate returns.

C. Using I.R.C. §66 to Escape Community Property Rules in Year of Divorce.

In Texas, a community property state, tax returns filed during periods of separation and in the year of divorce can be a trap for the unwary. It is important to note that, with the exception that will be discussed below related to I.R.C. §66, spouses are required to file either joint returns or married filing separate returns during periods of separation. In addition, in the year of divorce, one-half of all community income must be reported on the federal income tax return of the non-earning spouse, if earned prior to the date the decree becomes final. Community income includes wages, partnership income and other business income generated by a former spouse. This means where there is a gross disparity in earning power as between husband and wife, in the year of divorce the lower earning spouse will have a substantial tax liability for the one-half of all community income earned by the higher earning spouse up until the dissolution of the marriage. That lower income spouse may not have the assets to cover that liability.

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[1] Both authors are honored to have been listed as two of nine runners-up for the 2012 Tax Persons of the Year by T*ax Analysts 2013*© in the January 7, 2013 issue of *tax notes*®.
[2] Filing a separate return can result in the loss of important tax credits. For example, a married couple cannot file separate returns and claim the earned income tax credit.

1. **Requirements for I.R.C. §66**.

The United States Congress recognized this potential disparity and passed I.R.C. §66 as a solution for some spouses. However, the rules under I.R.C. §66 are very stringent and do not apply in all situations. In order for I.R.C. §66 to apply:

a. The spouses must live apart **at all times** during the calendar year;
b. They must not file a joint tax return for that year;
c. They must have earned income which is community income; and
d. They must not transfer any portion of that earned income between spouses except for the payment of child support.

If these conditions are met, then the earned community income, meaning wages and self employment income from trades or businesses or partnerships, will be reportable by the party who earned the income rather than one-half being allocated to the non-earning spouse under community property laws. Very importantly, all other community income such as interest, dividends or capital gains are split equally and must be reported one-half by each spouse, even under the application of I.R.C. §66.

It should be made clear that alimony payments, during the period of separation, destroy the applicability of I.R.C. §66 because they allow for the transfer of income. Any support and separate maintenance payments are also problematic to the applicability of I.R.C.§66. On the other hand, payment of child support during periods of separation is acceptable and does not impair the parties ability to use I.R.C. §66.

This means that where income is shared between spouses (except for child support) I.R.C. §66 will not apply. To avoid this egregious result, the earned income between spouses should be separately accounted for during the periods of separation. If there are other assets available to maintain and support the spouse, those assets should be used during the periods of separation. For example, if there is an existing bank account or investment account with sufficient assets to pay the house payment and other direct expenses, those assets should be used rather than the continuing earned income during the year of separation. All checks should be written by the spouse living in and using the house (electricity, etc.). If the earned income of the higher earning spouse is used to make house payments and pay other bills, the provisions of I.R.C. §66 will not apply.

2. **Client Doesn't Want I.R.C. §66 to Apply**.

If it is beneficial to your client to split earned income, he/she may be precluded from doing so under I.R.C. §66(b), unless such client notifies the other spouse prior to the due date of the return (April 15th) the amount of the community income to be split and the nature of such income (wages, interest earnings, partnership income, etc.).

3. Case Law.

Will the Internal Revenue Service look into these items? What has the Internal Revenue Service done in the past? Although not a targeted area, the Internal Revenue Service has shown a willingness to investigate I.R.C. §66 abuses. For example, in a case involving a Texas couple, Cline v. Commissioner, T.C. Memo 1982-44 (1982), the Clines, a separated but not yet divorced couple who were residents of Texas during 1977, filed married, filing separate returns. Mrs. Cline reported 100% of the community income as it was earned by her. She also paid 100% of the tax liability attributable to that income. In later years, the Internal Revenue Service audited Mr. Cline's return and allocated to him one-half of the community income, even though that tax had already been paid by Mrs. Cline on her return. The court upheld the determination by the Internal Revenue Service.

In another Texas case, Adams v. Commissioner, 82 T.C. 563 (1984), a Texas couple was divorced in 1977. The husband was a partner in a CPA firm. On each of their returns in the year of divorce, the couple reported their share of the partnership income up until the time of divorce. Mrs. Adams used a per share per day pro rata method of allocating income and Mr. Adams awaited the closing of the books and made an allocation based on the full year's earnings. Mr. Adams' return was subsequently adjusted, even though his manner of reporting the income was an acceptable method. Mr. Adams' method was inconsistent with the methods as between both spouses and resulted in a loss of revenue to the taxing authority based on the different methods used between the parties. The lesson learned in this case was that the parties must agree in the decree of divorce how business income of partnerships, S-corporations, or limited liability companies will be allocated in the year of divorce.

II. OTHER CONSIDERATIONS

A. Using I.R.C. §7703 to File as Head of Household Prior to Divorce

I.R.C. §66 helps spouses deal with inequities resulting from the application of community property laws during periods of separation and divorce. In addition, the Internal Revenue Code provides an additional benefit for separated spouses who maintain a household for a dependent child or children. That benefit is found at I.R.C. §7703.

1. **I.R.C. §7703**. Under I.R.C. §7703, a taxpayer may file an individual return claiming head of household status, even though married, if the following requirements are met:

   a. The taxpayer has a child;
   b. The taxpayer has paid greater than one-half of the expenses maintaining the household for that child;
   c. The parties were separated for greater than 6 months; and
   d. The spouse has not lived in the home for the last six months of the tax year.

This is an excellent opportunity for the taxpayer supporting a child to take advantage of the head of household rate schedules, rather than deciding between a Married Filing Separate tax return or the liability associated with a Joint Return. Remember though that I.R.C. §7703 deals with filing status only; to avoid reporting 1/2 of community income on the head of household return refer to I.R.C. §66(b) discussion above.

2. **The Noncustodial Spouse**. The logical extension of the rule under I.R.C. §7703 is that the separated spouse, who is not maintaining a household for the child(ren) will have to file under a married filing separate status.

III. OVERVIEW OF INNOCENT SPOUSE RULES.

Thankfully, legislation provides relief to certain spouses who have filed joint returns. The relief is found in I.R.C. §6015. For an account of the very interesting legislative history of this statute, enacted as part of the 1998 IRS Restructuring and Reform Act, see Bryan T. Camp, *Between a Rock and a Hard Place, 108* Tax Notes, 359 (July 18, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=911275; and Bryan T. Camp, *The Unhappy Marriage of Law and Equity in Joint Return Liability*, 108 Tax Notes 1307 (September 12, 2005): http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1505653.

After 1998, the following three types of relief are available:

A. §6015(b) Traditional Innocent Spouse Election

Taxpayers can elect this relief when:

1. A joint return has been filed for the taxable year;
2. There is an understatement of tax on the return attributable to the erroneous items of the nonrequesting spouse;
3. In signing the return, the requesting spouse did not know or had no reason to know, that there was such an understatement;
4. Taking into account all of the fact and circumstances, it is inequitable to hold the requesting spouse liable for the deficiency in tax; and
5. The request is made within two years of when IRS collection action first initiated.

B. §6015(c) Separate Liability Election

Taxpayer can elect this relief when:

1. In signing the return, the requesting spouse had no actual knowledge that there were erroneous items of the nonrequesting spouse;
2. At the time the election is filed, the requesting spouse is no longer married to, or is legally separated from, the nonrequesting spouse; or the requesting spouse was not a member of the same household as the nonrequesting spouse

at any time during the 12-month period ending on the date the election is filed; and

3. The request is made within two years of when IRS collection action first initiated.

C. §6015(f) Equitable Relief:

The Service will grant this relief when:

1. Relief is not available under I.R.C. §§6015(b) or (c); and
2. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable.

To help taxpayers and Courts with this "facts and circumstances" test, the IRS has published guidance laying out a variety of factors that its employees will use in deciding whether to grant relief requested under subsection (f). While these are very helpful for practitioners to know, the Tax Court has repeatedly emphasized that: "In section 6015(f) cases, however, we do not simply count [the IRS factors]. Likewise, we are not bound by them. The factors are guidelines we use in evaluating all of the relevant facts and circumstances to reach a conclusion." *Henson v. Comm'r*, T.C. Memo 2012-288.

The last published guidance from the Service on what factors it would consider in determining relief under subsection (f) was Rev. Proc. 2003-61. On January 5, 2012, the Service issued Notice 2012-8 which proposed a revenue procedure that, if finalized, would revise the factors and supersede Rev. Proc. 2003-61.

Notice 2012-8 states that, "until the revenue procedure is finalized, the Service will apply the provisions in the proposed revenue procedure instead of Rev. Proc. 2003-61 in evaluating claims for equitable relief under section 6015(f)." However, the Notice also states that a taxpayer requesting relief can choose either set of factors to be evaluated under.

As of the date this Article was submitted, the IRS has not issued a final Rev. Proc. that supersedes Rev. Proc. 2003-61. In *Sriram v. Commissioner*, T.C. Memo. 2012-91 the Tax Court said it would "continue to apply the factors in Rev. Proc. 2003-61, 2003-2 C.B. 296, in view of the fact that the proposed revenue procedure is not final and because the comment period under the notice only recently closed."

The main difference between the Rev. Proc. factors and the Notice 2012-8 factors is the Service's treatment of the abuse and financial control factors. The Service has eliminated "abuse" as a separate factor. Instead, the Service will now consider both spousal abuse and control of household finances as part of its determination on whether the requesting spouse knew or had reason to know of either the understatement of tax or the underpayment, as the case may be. If the requesting spouse was abused (and the Notice describes a broad concept of abuse in 4.03(2)(c)(iv)) or if the the other spouse kept control of the household finances by restricting the requesting spouse's access to financial information, then such situations could make this factor neutral or weigh in favor of the granting the requested relief.

IV. PROCEDURES FOR SEEKING SPOUSAL RELIEF.

Taxpayers can use a combination of administrative procedures and judicial procedures to get spousal relief.

A. Administrative Procedures to Seek Relief.

The IRS basically has two jobs: to determine the proper tax, which it then assesses, and to collect a properly assessed but unpaid tax. Taxpayers can seek spousal relief from the IRS in both the tax determination stage and tax collection stage.

First, taxpayers can seek spousal relief as **part of the deficiency proceedings**. Before 1998, this was the only procedure available. Taxpayers would ask for relief as part of the audit process, including any meetings with the Office of Appeals. If the IRS denied relief, that would be part of the Notice of Deficiency (NOD), which is the "ticket to the Tax Court." So taxpayers could then obtain Tax Court review of that denial as part of a petition contesting the deficiency.

Second, taxpayers can seek relief **as part of the Collection Due Process (CDP) hearing**. This second procedure is one Congress added in the 1998 IRS Restructuring and Reform Act (RRA 98). It is a post-assessment procedure. Before the IRS may use its full lien and levy powers, it must give taxpayers a chance to show why liens and levies were not appropriate collection actions. See §6220, 6230. The IRS does this through a special notice, called the CDP Notice, which gives taxpayers 30 days to ask for a CDP hearing with the Office of Appeals. As part of the hearing about the appropriateness of collection, taxpayers could ask for spousal relief. After all, it's not appropriate to collect a tax that should not have been assessed! The Office of Appeals makes its decision by issuing a document called a "Notice of Determination" (note the "NOD" abbreviation here--that's on purpose). Just like a "Notice of Deficiency," the "Notice of Determination" is a ticket to Tax Court review. If you want Tax Court review, you must have an NOD of some sort!

Notice that both the NOD procedures allow taxpayers to ask for spousal relief <u>as part of</u> another procedure (either review of a proposed deficiency or review of a proposed collection action).

Third, a taxpayer can seek spousal relief at any time after the IRS has begun collection action against him or her. This third procedure results in what is called a **"stand-alone" petition for relief.** It is not part of any other type of proceeding. The taxpayer can then appeal any denial of relief to the Office of Appeals who will issue a Notice of Determination that is, once again, a ticket to Tax Court review. See §6015(e).

Fourth, taxpayers can seek spousal relief through a claim for refund. This is a very different procedural posture from the other three. The first three procedures are all pre-payment procedures. However, a claim for refund is a post-payment procedure. That is, whenever a taxpayer has fully paid all the taxes assessed by the IRS, that taxpayer can file an administrative claim for refund, giving any good reason why the taxpayer may have overpaid. Section 6511 requires that administrative claims for refunds be filed either within 3 years after a return was filed or within 2 years after the payment was made. Remember, however, that refunds are not allowed as part of the relief under §6015(c), but only for (b) and (f) relief.

1. Preparing the Administrative Claim: Form 8857

In all of the above procedures, the taxpayer starts the administrative claim process with a Form 8857. Although claims for refund are made on Form 1040x, taxpayers would attach a Form 8857 to it. Further, although the Internal Revenue Manual (IRM) says that the IRS will accept any submission so long as it contains all the information, it is best to use Form 8857. That is the form the IRS designed and that is the form IRS employees are trained to interpret.

The basic rule here is: be as thorough as possible as time permits. Putting in the time and effort on the front end will not only save time and effort on the back end, but will also increase the chances of success. Thoroughness will not only help the IRS employee see the truth but will also demonstrate the taxpayer's determination to obtain relief. That determination itself may persuade an IRS employee to grant relief in a close case. This is especially true at the Office of Appeals level where the Appeals Officers are supposed to take "hazards of litigation" into consideration. For the particular rules that the Office of Appeals uses to review Spousal Relief denials, see IRM Part 25, Chapter 15, Section 12 (e.g. IRM 25.15.12).

The most important part of being thorough is finding documents that support the information given on Form 8857. For example, if the taxpayer claims abuse, try to find documentary evidence of that. If there are no police reports, or women's shelter reports, or medical reports, try at least getting witness statements. Abuse is not simply a one-time event. It is often a pattern of over-controlling that can be demonstrated by eyewitnesses over a period of time. On Part V of the form, try to provide as much documentation as possible about current financial position. Current economic hardship can play a huge role in getting spousal relief.

Experienced practitioners strongly suggest attaching documentation. The best practice here is to attach a narrative. Tell the story and methodically explain the basis for relief. If the taxpayer seeks equitable relief under subsection (f) the best practice is to include a chart summarizing each of the "equitable factors" contained in Rev. Proc. 2003-61, with an explanation of how those factors play out. Here's one suggestion:

Factor	**Favors IRS?**	**Favors Taxpayer?**	**Neutral?**
Marital Status			
Economic Hardship			
Knowledge or reason to know			
- mitigated by abuse?			
- mitigated by lack of control over finances?			
Legal Obligation to Pay			
Significant Benefit			
Compliance with Tax Laws			
Mental or Physical Health			
Total			

2. Timing

Administrative requests must be made timely. **As with much else in law, the first action to take to seek spousal relief is to figure out how much time to you have to file Form 8857. To do this, the best practice is to get a transcript of your client's accounts.** The easiest way to get transcripts is through the IRS e-Services route. If you are not a current e-Services user and/or lack access to the e-Service products, you must complete an on-line IRS *e-file* application and pass a suitability check which is the same check required by Electronic Return Originators. Publication 3112, (IRS e-file Application) contains additional details on the application and suitability processes. You can also get a transcript by calling the practitioner hotline (866-860-4259).

A request for spousal relief must not be made too soon or too late. Too soon is before the IRS has selected the return for audit or, for underpayment situations, before the IRS has taken a collection action against the requesting spouse. The following IRS actions open the door to requesting spousal relief: (1) sending the requesting spouse a §6330 Collection Due Process (CDP) Notice; (2) making a §6402 offset of an overpayment made by the requesting spouse; (3) filing suit against the requesting spouse in court; or (4) filing a claim for payment of the tax in any proceeding where the requesting spouse is a party or which involves property of the requesting spouse. Other actions that might be thought of as collection don't count, such as notice and demand, the filing of a Notice of Federal Tax Lien (NFTL) (although the IRS must send the CDP notice shortly after filing the NFTL.

Waiting more than 2 years after the first IRS collection jeopardizes spousal relief. The statute says that a taxpayer must seek subsection (b) or (c) relief within 2 years after the first collection action (listed above). Although the Treasury regulations also create a similar 2-year period for requests for equitable relief under subsection (f), the IRS has stated, in Notice 2011-70, that it will no longer enforce the regulation.

3. How the IRS Processes the Administrative Claim

Be sure to fill out the current version of the Form 8857, available on the IRS website. Send the Form to the Cincinnati Centralized Innocent Spouse Operation (CCISO) in the Covington, Kentucky IRS Campus. For clients under audit, or who have reached the point in the collection process where they get personal "service" from an IRS Revenue Officer, give a copy to the IRS employee. But the determination gets made in at the Cincinnati Centralized Innocent Spouse Operation (CCISO) in Covington, Kentucky. See IRM 25.15.8.2.2 (Collection Policy Decision) (08-17-2010). So always be sure to send it there.

The first action the IRS takes with each Form 8857 is to see whether it is filled out with enough information to make a determination. To be processable, the form must at least (1) identify the tax periods for which relief is requested; (2) identify the requesting spouse's taxpayer identification number, and (3) have a valid signature (one that says it is signed under the penalties of perjury). The IRS generally accepts faxed documents and considers faxed signatures valid. *See* IRM 25.15.7.5.2 (Screening Procedures) (02-25-2011). Competent practitioners, however, should give much more information than the bare minimum.

Once an IRS employee accepts a Form 8857 for processing, that employee will enter certain freeze codes in the requesting spouse's account to prevent further collection actions. *See e.g.* IRM 25.15.8.5.2.2 (Processable Form 8857) (08-17-2010). That's the good news. The bad news is that the CSED is suspended for the period during which the IRS is prohibited from levying against the requesting spouse. See §6015(e)(2).

After the IRS employee decides the submitted Form 8857 is processable, a CCISO employee will make a substantive decision about relief. That outcome will depend in part on how thorough a Form 8857 is presented. If the IRS denies relief, the requesting spouse has a right to go to the Office of Appeals. Good information about representing a client in Appeals is here: http://www.irs.gov/individuals/content/0,,id=98196,00.html.

4. <u>Judicial Review of the Administrative Procedure</u>

If the IRS (including the Office of Appeals) denies a taxpayer's request for spousal relief, it is generally possible to petition the Tax Court for review of the IRS decision, unless the request for spousal relief was part of a claim for refund. In that latter situation, the proper court is a federal district court or the U.S. Court of Federal Claims.

Whether spousal relief arises as part of a deficiency proceeding, a CDP proceeding or a stand-alone proceeding, the Tax Court now applies the same rules of procedure: it allows taxpayers to introduce new evidence and reviews the IRS decision *de novo*. In the past the Tax Court had different rules for different procedures but *Porter v. Commissioner*, 132 T.C. 203 (2009) changed that and illustrates how judicial review works.

In *Porter*, Suzanne Porter asked for equitable relief from the tax and penalties relating to mis-reporting of an early IRA distribution taken by her ex-husband. The IRS denied relief. When Porter asked the Tax Court to review the case, the IRS argued that the Tax Court should use an "abuse of discretion" review. That is, the Court should (1) just consider the information that the IRS considered, and (2) defer to the IRS decision unless the Tax Court thought it was so wrong-headed as to be an abuse of the IRS discretion. In contrast, Mrs. Porter asked the the Tax Court to use a "de novo" standard of review. That is, the Court should (1) consider new information that she wanted to give and (2) not defer to the IRS decision but instead make a completely independent decision.

Historically, the Tax Court had used de novo review for §6015(b) and (c) cases, but it had reviewed denials of §6015(f) relief using abuse of discretion standard. That was because the language in the Code gave the Tax Court jurisdiction over (b) and (c) cases but not (f) cases. However, when Congress passed the the Tax Relief and Health Care Act of 2006 (TRHCA), 120 Stat. 2922, 3061 (TRHCA), it explicitly gave the Court jurisdiction over stand-alone (f) petitions. The Court decided that it could apply the same standard of review for §6015(f) relief cases as for (b) and (c) cases. Accordingly, in cases brought under I.R.C. §6015(f), the Court now applies a de novo standard of review as well as a de novo scope of review.

Applying that standard in *Porter* the Court concluded that Ms. Porter was entitled to §6015(f) equitable relief. The Court found that the factors favoring relief were: she and her husband were divorced; she would suffer hardship if relief were not granted; she didn't receive a significant benefit beyond normal support from the IRA distribution; and she diligently complied with income tax laws in later years. Factors against relief were that Porter had reason to know of the IRA distribution because it appeared on the face of their return. Despite that, the Court allowed relief, noting that while it had upheld similar denials of relief under the abuse of discretion standard, the Court was no longer required to defer so much to the IRS. The Court decided that Porter's knowledge of the item was outweighed by the other factors and was further tempered by the fact that she regularly inquired into her husband's finances during the preceding year and he refused to answer or answered evasively.

The Ninth Circuit has recently upheld the Tax Court's decision that "de novo" review was the appropriate scope and standard for it to use in reviewing the Service's denial of spousal relief. *Wilson v. Commissioner*, 705 F.3d 980 (9^{th} Cir. 2013).

5. Reconsideration

The IRS has started a spousal reconsideration program, similar to audit reconsideration. See IRM 25.15.17. Generally, the IRS will reconsider a previously denied claim if the taxpayer shows that the taxpayer's previous request was denied because of some communication glitch. This is useful if a client tried to get relief on his or her own or if a client's spouse had previously sought administrative relief for the spouse and had failed, such as was the case in *Lantz v. Commissioner*, 132 T.C. 131 (2009), *rev'd* 607 F.3d 479 (7th Cir. 2010) (jailed dentist tried to obtain spousal relief for his wife from deficiencies attributed to his income from Medicare fraud).

B. **Seeking Relief Directly from a Bankruptcy Court**.

One additional procedure to obtain spousal relief may be bankruptcy. Section 505 of the Bankruptcy Code allows a bankruptcy court to "determine the amount or legality of any tax." Bankruptcy courts have used this authority to hear and decide requests for spousal relief. Sometimes bankruptcy courts require the debtor to first file an administrative claim. See *In re Shafman*, 267 B.R. 709, 714-717 (Bankr. N.D. W. Va. 2001) (after filing bankruptcy debtor filed adversary proceeding seeking spousal relief from the IRS and court had debtor first seek relief from IRS. IRS denial was reviewed (and in part reversed) by bankruptcy court). Sometimes they do not. See *In re Hinckley*, 256 B.R. 814 (Bankr. M.D. Fla. 2000) (debtor requested relief in an objection to IRS tax claim and court ruled on issue without requiring administrative determination, granting relief). See also *In re Waggoner*, 100 A.F.T.R.2d (RIA) 6426 (Bankr. N.D. Tex. 2007) (debtor sought spousal relief in an adversary proceeding and court rejected the IRS defense that the debtor had not first sought administrative relief).

As a statutory matter, there is no reason a bankruptcy court cannot, independently of the IRS, decide a request for spousal relief under either 6015(b) or (c). However, because the statutory language in 6015(f) says that "the Secretary may relieve such individual of such liability," bankruptcy courts have declined to make any independent judgment, but instead require the taxpayer to seek relief first from the IRS and then review the IRS decision under a more deferential standard than the Tax Court uses. See *In re Cummings*, 2005 Bankr. LEXIS 2040 (Bankr. S.D.Fla. 2005)

C. <u>Procedural Problems to Watch For</u>.

The reasonable practitioner should be aware of several procedural problems (or traps).

1. <u>The 2-year rule for §6015(b) and (c) relief</u>

In order to obtain relief under §6015(b) or (c), the requesting spouse must ask at the right time, which is the 2-year period after the Service initiates collection action against the requesting spouse. This 2-year rule creates some problems. Recall that Treas. Reg. 1.6015-5 says that the 2 year period begins to run from the earliest of the following IRS actions: (1) sending the requesting spouse a §6330 Collection Due Process (CDP) Notice; (2) making a §6402 offset of an overpayment made by the requesting spouse; (3) filing suit against the requesting spouse in court; or (4) filing a claim for payment of the tax in any proceeding where the requesting spouse is a party or which involves property of the requesting spouse. This is generally means a federal bankruptcy proceeding, although it might also include a state receivership proceeding or a probate proceeding.

The problem is that your client will not always know when the 2-year period has started. It is particular difficult to tell when the IRS may have performed a setoff of an overpayment that starts the 2-year period. That is why it is critical to obtain the account transcript for the years the requesting spouse seeks relief. Only a transcript will reveal whether and when the IRS has taken one of the collection actions that trigger the 2-year period.

2. <u>The One Bite Rule in §6015(g)</u>

The best way to think of the §6015(g) rule is to recall the difference between claim preclusion and issue preclusion. Claim preclusion operates to deny a litigant the ability to re-litigate a "claim" regardless of whether the litigant has new legal arguments or new evidence regarding that claim. Claim preclusion bars re-litigating any matter that was actually raised or that **could have been raised** in the prior proceeding. In contrast, issue preclusion operates to bar re-litigation of a particular legal issue when that issue was **<u>actually</u>** raised and litigated in a prior proceeding.

Section 6015(g) establishes a rule of issue preclusion. Section 6015(g) basically says that taxpayers get only one chance to ask for spousal relief from a court, whether under subsections (b), (c), or (f). Specifically, 6015(g) says that if a taxpayer "participated meaningfully" in any judicial proceeding where a court actually considered the issue of spousal relief, then that taxpayer is barred from asking any other court for relief.

The problem is knowing when taxpayers have taken that first bite. This problem comes up in many ways. It most commonly arises when the IRS has audited a return and the couple contests the proposed deficiency in Tax Court. If both spouses are parties to the petition, then it may be difficult for either spouse to later ask for spousal relief because they were supposed to do it as part of the deficiency proceeding. The problem is what does "participated meaningfully" mean? The Tax Court has a good discussion of this in *Deihl v. Commissioner*, 134 T.C. 156 (2010). In that case, the taxpayer and her husband were petitioners for petitions covering three years: 1996, 1997, and 1998. The 1996 pleadings had raised the issue of §6015 relief, but the taxpayer withdrew her claim for innocent spouse relief in the stipulation of facts. Neither of the petitions for 1997 and 1998 raised the issue. The Tax Court decided that (1) the issue was not actually raised because it was not in the pleadings for two of the years and it got dropped as uncontested in the other year, and (2) the taxpayer did not participate meaningfully in the deficiency.

This case has a pretty good discussion of what counts for meaningful participation. You can see that by why the Court thought Mrs. Deihl had not participated meaningfully in the deficiency proceeding:

> "Petitioner, who is not an attorney and did not complete her high school education, did not sign any court documents in the consolidated cases. She did not review the petitions or the stipulations of facts, nor did she agree to any of the stipulations. Mr. MacPherson and Mr. Hartmann did not discuss these documents with petitioner. In fact, she saw them for the first time at trial in the present matter. Petitioner did not meet with any IRS personnel, participate in any settlement negotiations with the IRS, or sit in on any such meetings between her attorneys and the IRS during the litigation in the consolidated cases. However, petitioner was called as a witness in the 2004 trial and testified briefly about certain expenses for entertainment and computers deducted by her and Mr. Deihl's S corporation."

Another time this problem comes up is when the IRS denies a claim, the taxpayer does not appeal, and then the taxpayer later submits a new claim for spousal relief. Can the taxpayer avoid the one-bite rule by failing to appeal the first denial? The regulations say no. A requesting spouse is entitled to only one final administrative determination of relief for a given assessment, unless the spouse was still married at the time of the first request and so did not qualify for (c) relief. In that case the taxpayer can later ask for (c) relief and take an appeal. See the discussion in *Barnes v. Commissioner*, 130 T.C. 248 (2008), where the court dismissed an §6015(f) claim because the IRS had previously denied what was essentially the same claim and the taxpayer had not appealed that denial.

3. The Intervening Spouse

In *Nunez v. Comm'r*, T.C. Memo 2012-121, the tax liability arose from the operation of a California business. The issue was whether the requesting spouse met the 7th "threshold" conditions for relief in Rev. Proc. 2003-61, § 4.01, that the tax liability be solely attributable to the non-requesting spouse unless the reason the requesting spouse had joint liability was solely because of community property law. Ms. Nunez claimed that income and expense items were attributable to her solely due to the operation of California's community property law. Her ex-husband had asked to intervene during the administrative process but had not responded to either of two letters asking for information and so Appeals closed the case by offering the taxpayer full relief. Eventually, the ex-husband contacted Appeals and convinced them that the requesting spouse was co-owner of the business and so Appeals changed its decision to a grant of 50% relief, rejecting her testimony that she was listed on the business documents only because of California law.

The taxpayer rejected the offer of partial relief and sought review in the Tax Court. Again, the ex-husband intervened and his testimony helped convinced the Tax Court that the requesting spouse was not only the co-owner but that she had actively participated in the business. The Court concluded: "After weighing the testimony and evidence in this fact-intensive and nuanced case, we hold petitioner is not entitled to relief from joint and several liabilities for the joint income tax for each of the years at issue."

4. Representing Non-Requesting Spouses

Non-requesting spouses face problems as well. Rev. Proc. 2003-19; 2003-1 C.B. 371 sets out the rights of non-requesting spouses. Basically, the non-requesting spouse can participate in the administrative process but has only limited rights to judicial review.

Specifically, if the requesting spouse gets an administrative denial and takes it to Tax Court, the non-requesting spouse can intervene and participate (if the non-requesting spouse learns of the Tax Court petition). See *King v. Commissioner*, 115 T.C. 118 (2000) in which a nonrequesting spouse was allowed to intervene. See also T.C. Rule 325.

However, if the IRS grants relief administratively, there is precious little the non-requesting spouse can do about it. In Maier v. Commissioner, 119 T.C. 267 (2002), The IRS granted relief under §6015(f) to Judith Maier during the administrative proceedings. Husband John Maier filed a petition in Tax Court seeking a redetermination of the innocent spouse relief to Judith. Noting that it is a court of limited jurisdiction, the Tax Court held that if the Judith did not file a petition for review of the Internal Revenue Service determination, John could not file a petition and oppose the administrative determination granting relief as Congress had not given the Tax Court with jurisdiction to hear his case.

V. RECENT DEVELOPMENTS

A. Changes in Equitable Factors.

On January 5, 2012, the Internal Revenue Service (IRS) released Notice 2012-8, 2012-4 I.R.B. 309, which proposed a revenue procedure that, if finalized, would revise the factors the IRS will use to evaluate a requesting spouse's claim for equitable relief under section 6015(f) and would supersede Rev. Proc. 2003-61.

Notice 2012-8 states that, "until the revenue procedure is finalized, the Service will apply the provisions in the proposed revenue procedure instead of Rev. Proc. 2003-61 in evaluating claims for equitable relief under section 6015(f)." As of the date this Article was submitted, the IRS has not issued a final Rev. Proc. that supersedes Rev. Proc. 2003-61. However, Notice 2012-8 also states that a taxpayer requesting relief can choose either set of factors to be evaluated under. The major conceptual change in the Notice was to take what had been a separate factor---abuse---and use it instead to ameliorate the knowledge factor.

In *Sriram v. Commissioner*, T.C. Memo. 2012-91 the Tax Court said it would "continue to apply the factors in Rev. Proc. 2003-61, 2003-2 C.B. 296, in view of the fact that the proposed revenue procedure is not final and because the comment period under the notice only recently closed."

B. Elimination of the 2-year period for Requesting (f) Relief.

Treas. Reg. § 1.6015-5(b)(1), implemented by Revenue Procedure 2003-61, §4.01(3) both provide that a requesting spouse must file a claim for equitable relief (whether under §6015(f) or §66(c)) no later than two years after the date of the Service's first collection activity.

The Tax Court had consistently held that the Treasury Regulation was invalid. Just as consistently, it was overruled by Circuit Courts of Appeal. See Bryan T. Camp, *Interpreting Statutory Silence,* 128 Tax Notes 501 (August 2, 2010). On April 18, 2011 three U.S. Senators and forty-nine Congressmen sent letters to IRS Commissioner Douglas Shulman urging the IRS to reconsider its position of applying a two year limitations period to §6015(f) relief requests. The Congressmen reasoned that the IRS was violating “the spirit of the law,” which was intended to make it easier for taxpayers to apply for innocent spouse relief. The Senators wrote that “the two-year limitation served to deny equitable relief to the very taxpayers the law was designed to reach.”

The Service responded with Notice 2011-70, saying it would not enforce the regulatory 2-year rule. Sure enough, in §4.01(3) of Notice 2012-8, the Service has proposed removing the 2-year rule from its evaluation of §6015(f) claims. Instead, the Notice provides that requests for equitable relief under §6015(f) or §66(c) must be filed before the expiration of the period of limitation for collection under §6502, or, if applicable, the period of limitation for credit or refund under section 6511.

C. Ninth Circuit Upholds Tax Court De Nove Standard and Scope of Review.

Wilson v. Commissioner, 705 F.3d 980 (9^{th} Cir. 2013) is a Ninth Circuit case where the panel spit 2-1 over whether the Tax Court properly reviewed the IRS decision to deny spousal relief to Ms. Wilson. In its review the Tax Court had considered new evidence presented by Ms. Wilson that she had not presented during the consideration of her case by the IRS Office of Appeals. The Tax Court also applied a de novo standard of review, essentially substituting its judgment for the IRS’s judgment. In light of the new evidence, the Tax Court decided that Ms. Wilson was eligible for relief.

The government appealed two issues: (1) whether the Administrative Procedure Act limited the Tax Court’s review to only such information as was in the administrative record; and (2) whether, since the grant of §6015(f) relief was discretionary on the part of the IRS, the Tax Court could just substitute its judgment for that of IRS, or must instead simply review the decision to ensure the IRS did not abuse its discretion.

As to the first issue, the Ninth Circuit found it of great significance that when Congress gave the Tax Court jurisdiction to “determine” §6015(f) “petitions” for relief, it used the words "petition" and "determine" rather than "appeal" in § 6015(e). The Circuit then explained that giving the Tax Court the ability to hear new evidence made sense in light of the statutory placement of the Tax Court in tax administration and said that not to allow the Tax Court the ability to hear new evidence and conduct a de novo hearing in §6015(f) stand-alone petitions would create an anomaly with the Court’s ability to do so when §6105(f) relief was raised during a deficiency proceeding.

As to the second issue, the Ninth Circuit again decided to read the “plain” language of §6015(e) as allowing the Tax Court to apply a de novo standard of review. Here the word was “determine” which the Ninth Circuit thought was good enough. The court agreed with the government that it was illogical for the Tax Court to “review” the IRS decision for abuse of discretion on the basis of evidence that the taxpayer may not have presented to the IRS during the administrative process. However, since the Tax Court acted properly to allow new evidence, this logic cut against the government’s contention that the Tax Court was limited to abuse-of-discretion review.

Appendix A. COMMUNITY VS. SEPARATE PROPERTY

Divorcing spouses' tax liabilities are also affected by characterizations of community versus separate property.

A. Texas Law.

In Texas, all property owned by either spouse is community or separate property. Property acquired during marriage is community property. The spouse claiming any of the property to be separate property has the burden of proof to show that the property is that spouse's separate property.

B. Presumption of Community.

Property possessed by either spouse during marriage is presumed to be community. The separate property nature of the item must be proven.

C. Income vs. Gains From Separate Property.

a. Income from separate property is community income.

b. Capital gains from separate property are allocated to the spouse owning the separate property.

D. Commingling and Property-Tracing.

Separate property assets may become so commingled with community property that they lose their identity as separate property. *Newland v. Newland*, 529 S.W.2d 105 (Tex. Civ. App.–Ft. Worth 1974, writ dism'd.)

E. Case Law.

Ascertaining whether assets are community or separate property requires a fact intensive analysis. In Oliver v. Commissioner, T.C. Memo 2011-43 (2011), the Tax Court determined the status of multiple assets. The petitioner, Mrs. Oliver, did not file federal income tax returns for years ended 2000, 2001, 2002, and 2004. Thus, the Internal Revenue Service created substituted returns on the petitioner's behalf. The Internal Revenue Service issued a notice of deficiency to the petitioner. The petitioner filed a petition with the Tax Court with the central issue being the designation of assets as community or separate property. The petitioner had to file married filing separately because she failed to file a married filing jointly return before the notice of deficiency was issued.

Spouse's Income

During the years at issue the petitioner's husband, Mr. Oliver, received wages, dividends, and unemployment compensation (collectively "Mr. Oliver's income). While the petitioner argued that Mr. Oliver's income was his separate property she failed to produce any evidence, to overcome the community property presumption. The Court found that the petitioner had to include her community property share of Mr. Oliver's income on her returns.

Social Security Benefits

The Internal Revenue Service argued that Mr. Oliver's Social Security benefits were community property and must be included on the petitioner's returns. The Court held that Social Security benefits are a spouse's separate property, thus the petitioner did not have to include her share of Mr. Oliver's Social Security benefits.

Sale of Stock

In 2001 and 2001 the Olivers sold stock and received interest income and capital gain from the sale. The petitioner argued that the interest and capital gains were the separate property of Mr. Oliver. However, the community property presumption applies and the petitioner again failed to offer any evidence to overcome the presumption. Thus, the petitioner had to include her community share of the interest income and capital gain received from the sale of the stock.

Monetary Settlements

Mr. Oliver received a settlement of $201,000 from his former employer. The settlement agreement stated that the settlement was for "alleged personal injuries, including emotional distress and compensatory damages; no portion of which represents payment of back, severance, or front pay or lost benefits."

The community property presumption does not apply to recovery for personal injuries. Any compensation for injuries to one's spouse for "personal well-being" is deemed to be separate property. Mr. Oliver's settlement agreement provided that the settlement was for personal injuries suffered by Mr. Oliver. The Court held that the entire settlement was the separate property of Mr. Oliver thus the petitioner did not have to include any of the settlement on her return. The Court relied on the specific language of the settlement agreement to determine that none of the settlement represented income, which would be community property.

Real Estate Sales

The petitioner inherited a house from her mother in 1995. In 2004, the Olivers sold the house under an installment agreement. They received $2,500 in earnest money and a promissory note for $62,500. The status of property is affixed at the time it is received. The house was an inheritance, designating it as separate property. Property will retain its original status unless it is changed by agreement or operation of law. The Olivers never made an agreement to convert the property to community property therefore the house was the petitioner's separate property at the time it was sold.

The sale qualified as an installment sale under I.R.C. §463(b)(1), therefore interest income and capital gains received must be reported using the installment agreement method. I.R.C. §453(b)(1) controls the reporting of income from an installment sale. Under an installment sale each payment consists of a recovery of the basis, capital gains, and interest. Ordinarily, the petitioner could have treated all the capital gain and recovery of the basis as her separate property because the house was her separate property. However, the promissory note required the buyers to make the payments to both the petitioner and Mr. Oliver and the mortgage listed both as the mortgagees. The Court determined that the Oliver's intention was for the installment payments to become community property. The earnest money was not discussed in the promissory note therefore it was classified as the petitioner's separate property.

Appendix B. IMPORTANT TERMS AND CONCEPTS

A. Assessment.

This is the act of recording a tax liability in the IRS computers. The term is defined in IRC §6203 and the authority for the IRS to make assessments is given in IRC §6201. Treasury Regulation 301.6203-1 gives more details on how the IRS must make assessments. Assessments are generally made in the Campuses once a week on a Form 23-C. This form is the aggregate of all assessments processed that week. Individual taxpayer accounts are not reflected on this form. To see the date of an assessment for any particular taxpayer, one needs to see the transcript.

Most assessments are made on the basis of the taxes shown on filed returns. That is, the IRS uses the numbers shown on the return to make the assessment.

B. Understatement.

An understatement of tax is when the taxpayer fails to report the correct tax on the return. The term is defined in IRC §6662(d)(2) as part of the rules regarding the accuracy related penalty. This might be either because the taxpayer failed to report income or took improper deductions, exclusions or credits. Either way, the taxpayer understated the tax due.

C. Deficiency.

A deficiency is basically the difference between the tax shown on the filed return and the correct tax. The term is defined in IRC §6011. Understatements of tax are generally not caught unless and until the return is audited. When the IRS examines a return and discovers that the reported tax is less than the correct tax, the different is called a deficiency. Before the IRS can assess the deficiency (and so properly reflect and collect the correct tax), it must send the taxpayer a document called the Notice of Deficiency (NOD). Issuing the NOD gives the taxpayer 90 days (150 days if they are out of country) to petition the Tax Court to review the proposed deficiency. Deficiencies arise when the IRS figures out that the taxpayer has understated the correct tax.

D. Underpayment.

An underpayment is when a taxpayer files a return but does not pay in full the amount of tax shown on the return. The term is not explicitly defined in the IRC. Underpayments are collected by the IRS through a 3-stage collection process that starts with a series of notices mailed to the taxpayer's last known address. Most underpayments result from taxpayers who properly self-report the correct tax but just do not fully pay it with the return. About a third of underpayments result from deficiencies assessed by the IRS.

E. Overpayment.

An overpayment is when a taxpayer has paid more tax than the taxpayer actually owes. While the term is not explicitly defined in the IRC, §6401 does say that the term includes any payments made after the close of the assessment or collection period (see ASED and CSED below). These are called "statutory overpayments" because they are not really payments of more taxes than are owed; they are just paid beyond the point that the IRS can legally collection them. Of course, for there to be an "over "payment there must first be a payment. Generally, it is not difficult to tell when a taxpayer has paid a tax. However, sometimes taxpayers might send money to the IRS as a "deposit" and not a "payment." For example, when a taxpayer receives a Notice of Deficiency and wants to contest the deficiency in Tax Court but also wants to stop the running of interest and failure to pay penalties, the taxpayer may send in an amount equal to the deficiency of tax but explicitly designate it as a "deposit." That way, the the Tax Court can still hear the case (because if the taxpayer actually paid the proposed deficiency, there would no longer be a deficiency for the Tax Court to have jurisdiction over). For more on the distinction between payments and deposits see the discussion in *Deaton v. Comm'r*, 440 F.3d 223 (5th Cir. 2006).

F. Refund.

This is the amount of an overpayment that the IRS returns to the taxpayer. The term is not explicitly defined in the IRC but is implicitly defined in IRC §6402 which is the section that authorizes the IRS to return overpayments to taxpayers. **Important: an overpayment is not the same as a refund!!** While IRC §6402 authorizes the IRS to refund overpayments to the taxpayer, it also says the IRS may instead "credit the amount of such overpayment....against any liability in respect of an internal revenue tax on the part of the person who made the overpayment...." Section 6402 also authorizes the IRS to use the overpayment to satisfy debts the taxpayer may have against various other federal or state agencies who notify the IRS of such debt. This includes child-support payments, state income taxes, or debts to repay other federal transfer programs (such as Social Security).

G. ASED (Assessment Statute Expiration Date).

Generally, IRC §6501 gives the IRS three years from the due date of a return to assess the tax. What this means in practice is that although the IRS accepts most returns as filed and assesses the tax shown on the return, it still may seek to assess a Deficiency (see above) at any time within the three year limitations period. In the computer transcripts of account, the last date by which the IRS must assess is called the Assessment Statute Expiration Date, or ASED. Many events can suspend, or toll, the ASED. For example, if the IRS thinks there is a deficiency, the IRS will send the taxpayer a Notice of Deficiency, which allows the taxpayer 90 days to obtain review in Tax Court. Section 6213 prohibits the IRS from assessing the deficiency pending Tax Court review and §6503 says that the ASED is suspended during the time the IRS is prohibited from assessing. Another common reason for suspension is when the taxpayer agrees to extend the ASED by signing a Form 872 or 872-A.

H. CSED (Collection Statute Expiration Date).

Generally, IRS §6502 gives the IRS 10 years from the date of assessment to collect the assessed tax. As with the ASED, many events toll the CSED. Notably, asking for an Offer In Compromise (IRC §7122) or for a Collection Due Process Hearing (IRC §6020 or 6030) will suspend the CSED.

Appendix C: 2012 CASES

Case Name	Type of Procedure	Outcome	Notes	Relief
CORY CHAPUT, Petitioner, and RACHEL HOLBERT, Intervenor v. CIR, *T.C. Summary Opinion 2012-69*; *2012 WL 2912908*	Stand Alone	Reverse	The government failed to demonstrate that Petitioner had actual knowledge of Intervenor's cancelation of indebtedness income and additional wages.	c
SARI DEIHL v. CIR, *T.C. Memo. 2012-176*; *2012 WL 2361518*; *103 T.C.M. (CCH) 1935*	Stand Alone	Partial	Petitioner was denied (b) relief because she could not show that the erroneous items giving rise to the tax understatement were attributable solely to her deceased husband. Petitioner was granted relief for 50% of tax liabilities under (c) because half of the erroneous deductions were not attributable to her. Petitioner was denied (f) relief because she could not show nominal ownership or duress.	b, c, & f
JAVIER GAITAN, Petitioner, AND MONICA GAITAN, Intervenor v. CIR, Respondent, MONICA GAITAN, Petitioner v. CIR, Respondent, *T.C. Memo 2012-3*; *2012 WL 10801*; *103 T.C.M. (CCH) 1010*	Stand Alone	Partial	Petitioner was not eligible for (b) relief because the erroneous items from clothing-export business were attributable to him. Petitioner was, however, entitled to (c) relief because his wife, and not him, knew the costs of the goods sold were inflated on the joint return. The deficiency was allocated under Section 6015(d). Because the relative fractions of the joint ownership were unclear, the court followed the regulatory 50-50 allocation. Because the business was jointly owned, neither was entitled to (f) relief. The deficiencies were not solely attributable to a single spouse. Further, Petitioner's wife failed to establish the abuse exception to be entitled to (f) relief.	b, c, & f
ALVARO GALLEGO v. CIR, *T.C. Summary Opinion 2012-97*; *2012 WL 4510925*	Stand Alone	Reverse	On a Motion for Reconsideration, Petitioner was entitled to (f) relief because his former spouse misappropriated funds intended for the repayment of a portion of the tax liability when she fled the country.	f
SHANNON GALVAN v. CIR, *T.C. Summary Opinion 2012-112*; *2012 WL 5499833*	Deficiency	Sustain	Petitioner's case was dismissed as untimely. After Petitioner failed to timely challenge the first final determination denying her request for innocent spouse relief, her second, third, and fourth Form 8857's were not qualifying requests for relief.	f
GRAY v. CIR, 138 T.C. 13 (2012)	CDP/ Stand Alone	Partial	Issue was whether petition was timely for court's review under CDP, or whether the Court had stand-alone jurisdiction to review determinations of innocent spouse relief or	f

Case Name	Type of Procedure	Outcome	Notes	Relief
			interest abatement. The Court held that the petition was untimely for CDP review but was timely under Section 6404(h) to review determination not to abate interest. Petitioner argued that, because she asked for spousal relief during her CDP hearing, she had 90 rather than 30 days to file the petition. The Court concluded that further proceedings were necessary to determine whether it had jurisdiction over Petitioner's innocent spouse claims and whether the claims raised in the CDP hearing were sufficiently dissimilar from claims that she had received a prior final determination on.	
KATHLEEN HAAG v. DOUGLAS SHULMAN, CIR, 683 F.3d 26 (1st Cir. 2012)	Appeal	Affirm	After Taxpayer's four prior lawsuits had been dismissed, Taxpayer appealed from a fifth action that the Tax Court dismissed on summary judgment. The First Circuit found the exception to res judicata in 6015(g)(2) did not apply to Taxpayer. Taxpayer had participated meaningfully in the prior proceedings independently from her husband. And, although the government had changed its interpretation regarding the statute of limitations applicable to (f) relief, res judicata does not take into account intervening changes to the law.	f
FRANCES HARRINGTON, Petitioner, and KIRK HARRINGTON, Intervenor v. CIR, *T.C. Memo 2012-285*; *2012 WL 4739527*; *104 T.C.M. (CCH) 423*	Deficiency	Sustain	Petitioner obtained partial relief from her deficiency but petitioned the Court for full relief. Petitioner's former spouse intervened to oppose relief, and then Petitioner changed petition request to "validate the IRS determination" in light of Intervenor's opposition. The Court credited Petitioner's testimony over Intervenor's.	c
GLENELL HENSON, Jr., Petitioner v. CIR and STEPHANIE HENSON, Intervenor, *T.C. Memo 2012-288*; *2012 WL 4815166*; *104 T.C.M. (CCH) 441*	Stand Alone	Sustain	Petitioner's former spouse intervened in the case to oppose relief, and had previously objected to Petitioner's innocent spouse request when the IRS initially denied relief. Here the Court favored the testimony of the intervening former spouse over the Petitioner's.	f
SHARON HUDGINS v. CIR, *T.C. Memo 2012-260*; *2012 WL 3964890*; *104 T.C.M. (CCH) 283*	Stand Alone	Sustain	Petitioner failed to satisfy the safe harbor requirements for lack of knowledge or economic hardship. In applying balancing factors, the Court denied Petitioner equitable relief based on the fact that Petitioner made fraudulent transfers of rental properties to	f

Case Name	Type of Procedure	Outcome	Notes	Relief
			relatives and failed to disclose her interest in another property.	
THERESA KARAM v. CIR, ***2012 WL 5395172 [110 AFTR 2nd 2012-6540] (6th Cir. Nov. 5, 2012)***	Appeal	Affirm	The 6th Circuit Court of Appeals held that the Tax Court did not abuse its discretion in finding that Taxpayer received a significant benefit from the unpaid tax liability where Petitioner used that money to obtain a Ph.D.	f
KOPROWKI v. CIR, 138 T.C. 5 (2012)	Stand Alone	Sustain	Petitioner was barred from relief by res judicata and did not qualify for Section 6015(g)(2) exceptions. The Court decided decisions of "small tax" cases under Section 7463 were entitled to res judicata.	f
DAVID CHARLES LADEHOFF v. CIR, ***T.C. Summary Opinion 2012-15; 2012 WL 612501***	Stand Alone	Sustain	Petitioner was denied (b) and (c) relief because he prepared the tax return and there were erroneous calculations attributable to him. Petitioner did not meet (f) threshold requirements because he failed to establish the abuse exception to the non-attribution requirement even though there were two police reports of spousal abuse.	b, c, & f
MINIHAN v. CIR, 138 T.C. 1 (2012)	Stand Alone	Reverse	Under state law, Petitioner owned 50% of a joint bank account that IRS seized to satisfy former spouse's liability. Thus, Section 6015(g)(1) gave Petitioner the right to receive a refund of her levied share of the account, if she could satisfy (f) requirements for relief. The Court, thus, rejected the IRS's motion for summary judgment, but left for trial whether Petitioner was entitled to (f) relief.	f
CATHERINE MARIE NUNEZ, Petitioner, AND ROBERT URIARTE, Intervenor v. CIR, ***T.C. Memo 2012-121; 2012 WL 1435002; 103 T.C.M. (CCH) 1664***	Stand Alone	Sustain	Petitioner sought full relief under (f) after the IRS granted 50% relief under (c). The Court rejected the CIR and Petitioner's contention that any item attributable to Petitioner was solely due to operation of state community property laws, and instead found that Petitioner was a co-owner and actively involved in the business that gave rise to the tax liabilities. Accordingly, Petitioner did not meet the threshold requirements for relief from joint and several liability.	f
ALLISON T. O'NEIL, Petitioner, and MICHAEL O'NEIL, Intervenor v. CIR, ***T.C. Memo 2012-339; 2012 WL 6027114; 104 T.C.M. (CCH) 724***	Stand Alone	Sustain	Petitioner was denied relief under the safe harbor provision because she could not show that she reasonably believed her ex-husband would pay the joint tax liability. The Court also found the multifactor balancing test for equitable relief under Section 6015(f) weighed against her, and that a levy would not cause significant economic hardship.	f

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Case Name	Type of Procedure	Outcome	Notes	Relief
TU PHAM v. CIR, *T.C. Memo 2012-171*; *2012 WL 2344773*; *103 T.C.M. (CCH) 1913*	Stand Alone	Sustain	Relief under (b) and (c) was denied because the petition was filed more than two years after IRS began collection activities. Petitioner challenged the form and content of the IRS's final determination denying innocent spouse relief under (f) as untimely filed. However, the Court sustained the denial of (f) relief because the IRS was not required to address the merits of Petitioner's claim when its reasonable regulations at the time of filing rendered the petition untimely—despite the IRS's change in position at a later time.	b, c, & f
BENJAMIN SOTUYO AND CHRISTINA CARO v. CIR, *T.C. Summary Opinion 2012-27*; *2012 WL 1021306*	Stand Alone	Reverse	Husband sought (b), (c), and (f) relief while Wife sought (f) relief. Husband was not entitled to (b) relief because he had reason to know of Wife's income. However, Husband was entitled to (c) relief because the government failed to show that Husband had actual knowledge of Wife's income that led to the deficiency at the time he signed the return, and the entire amount of the deficiency was attributable to Wife. The Court did not address Husband's (f) claims in light of full relief being granted under (c). Because the Court found that the deficiency was fully attributable to Wife, the Court denied her (f) relief because she could not establish that any of the attribution exceptions applied to her—particularly with regard to abuse.	b, c, & f
RAJALAKSHMI SRIRAM v. CIR, *T.C. Memo 2012-91*; *2012 WL 1021315*; *103 T.C.M. (CCH) 1482*	Stand Alone	Sustain	Petitioner only partially satisfied threshold requirements for (f) relief and failed to rebut the presumption that 50% of the tax liabilities were attributable to her share of rental and interest income. The Court further found that Petitioner did not meet safe harbor conditions and that the facts and circumstances test also did not entitle her to equitable relief. Significant to the Court's analysis was that Petitioner failed to establish the abuse factor, and could not offset the economic benefit and knowledge factors that weighed heavily against her.	f
STEVEN STANWYCK, Petitioner, AND JOAN STANWYCK, Intervenor v. CIR, *T.C. Memo 2012-180*; *2012 WL 2476255*; *103*	Stand Alone and CDP	Sustain	The Court denied (b) relief because charitable contribution deductions to a local foundation were attributable to Petitioner who served as chief financial officer of the foundation that he created for his own benefit. The Court	b, c, & f

Case Name	Type of Procedure	Outcome	Notes	Relief
T.C.M. (CCH) 1955			denied (c) relief on same grounds. The Court found that petitioner failed to meet threshold requirements for (f) relief because he was solely responsible for the underpayment and did not qualify for any exceptions.	
SHERRY WICKMAN, Petitioner, AND KEVIN WICKMAN, Intervenor v. CIR, *T.C. Summary Opinion 2012-8*; *2012 WL 222940*	Stand Alone	Reverse	After filing of the petition, but prior to trial, Petitioner and the IRS reached a stipulation that Petitioner would be entitled to (f) relief—Intervenor challenged. The Court held that Petitioner met safe harbor requirements for (f) relief, particularly on the economic hardship factor. Petitioner was hearing and speech impaired, held a twelfth grade education from a vocational school, was unemployed, did not receive alimony or child support from Intervenor, received her sole source of income from Social Security to support herself and children, had substantial non-tax debt, did not own a car, and relied on public transportation as her sole source of mobility. Applying national and local standards, Petitioner's income did not exceed expenses and Petitioner would face economic hardship if (f) relief were denied.	f
NEIL YOSINSKI v. CIR, *T.C. Memo 2012-195*; *2012 WL 2865808*; *104 T.C.M. (CCH) 55*	Stand Alone	Partial	Petitioner was entitled to (c) relief for $37 of unreported taxable interest income attributable to his former spouse. In denying (f) relief, the Court rejected Petitioner's argument that his tax liability was attributable to his former spouse because he was the one who sold securities and made distributions from an IRA account creating the liability. He did so to comply with a Court order to make monthly spousal maintenance and child support payments to his former spouse. Petitioner also had reason to know that his former spouse would not pay the tax liabilities.	c & f
ANDREW YOUNG and SONDRA YOUNG v. CIR, *T.C. Memo 2012-255*; *2012 WL 3822236*; *104 T.C.M. (CCH) 268*	Stand Alone	Sustain	This case is procedurally unique in that Petitioner raised innocent spouse relief as an affirmative defense to deficiencies. The government favored granting relief, and non-requesting spouse—former husband—opposed relief. Because the government normally bears the burden of proving actual knowledge but favored relief, the Court resolved conflict by applying preponderance of evidence standard to the evidence	c

Case Name	Type of Procedure	Outcome	Notes	Relief
			presented by all three parties. The Court held for the Petitioner, finding that she had no knowledge of the facts giving rise to her former spouse's erroneous deductions and that the deficiencies were solely attributable to her former spouse.	
FARZANA ZAHER, Petitioner, AND MOHAMMAD ZAHER, Intervenor v. CIR, ***T.C. Memo 2012-11; 2012 WL 75144; 103 T.C.M. (CCH) 1071***	Stand Alone	Reverse	The Court found that Petitioner met the threshold requirements for (f) relief and that three of the remaining factors favored relief, two weighed against relief, and the rest were neutral. In granting Petitioner relief, the Court looked to the other facts and circumstances and emphasized the Intervenor's "egregious misconduct."	f

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PORTABILITY – PLANNING AND COMPLIANCE ISSUES

By Lora G. Davis*

BACKGROUND

"Portability" allows a surviving spouse to "port" or use his or her deceased spouse's unused estate and gift tax exemption amount. The portability concept has been discussed for many years as being sound tax policy. It was recommended in 2004 by a task force comprised of representatives from the American Bar Association ("ABA") Section of Taxation, the ABA Section of Real Property, Probate and Trust Law, the American College of Tax Counsel, the American College of Trust and Estate Counsel ("ACTEC"), the American Bankers Association and the American Institute of Certified Public Accountants.[1] Although it appeared in several congressional bills subsequent to that time, portability was not available until 2011 with the enactment of the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010 (the "2010 Tax Act"). The provisions allowing portability were set to expire on December 31, 2012 under the 2010 Tax Act, however, they were permanently extended under the American Taxpayer Relief Act of 2012 ("ATRA").

In spite of the possible transitory nature of portability, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued helpful guidance with respect to the application of portability prior to the passage of ATRA. On October 11, 2011, Notice 2011-82 was issued to alert executors (and their advisors) of the need to file a timely estate tax return to elect portability for decedents whose deaths occurred after December 31, 2010.[2] The provisions of Section 2010(c) require an "election" by the executor on a timely-filed estate tax return in order for portability to apply. The IRS recognizes that many estate tax returns will be filed for the sole purpose of electing portability. Notice 2011-82 clarifies that if portability is elected, the following requirements must be met:

- A complete and timely-filed estate tax return (including extensions) must be filed; and
- The "election" required by the statute will be deemed to have been made by the timely filing of a "complete and properly-prepared"[3] estate tax return until a revised estate tax return form that provides for making the election is released.

The notice goes on to state that an executor who does not want to make a portability election, but who otherwise timely files a complete return, must follow Form 706 instructions in order to make such opting-out election (even though no such instructions existed at the time). An executor who does not want to make a portability election and who otherwise is not obligated to file an estate tax return can simply not file a return to opt out of portability. In addition, the notice also clarifies that a portability election is not permitted for decedents whose death occurred on or before December 31, 2010. Comments were requested on several issues that were identified for consideration in the drafting of temporary regulations, including calculating the DSUE amount, ordering exemption usage and understanding the scope of the unlimited return review period allowed to assess additional tax.

Notice 2012-21,[4] issued on March 5, 2012, granted certain estates an additional six months to file an estate tax return to elect portability. The discussion portion of the Notice indicates that several comments received on Notice 2011-82 raised concerns about estates of decedents who died early in 2011 whose executors did not have the benefit of any guidance regarding portability. Those executors may have not understood the need for filing a complete estate tax return, or may not have even been aware of a requirement for filing to preserve portability for the surviving spouse. In addition, in those cases the executor would also not have been aware of the need to file an extension to file a return. Accordingly, the IRS and Treasury used their powers under Section 6081(a) to grant a six-month extension of time to file after date of death to estates of decedents whose death was after December 31, 2010 and before July 1, 2011, so long as the fair market value of the estate did not exceed $5 million and the decedent was survived by a spouse. In order to receive this special extension, the executor is required to file Form 4768 with the proper IRS service center no later than 15 months from the decedent's death, with the notation "Notice 2012-21, Extension for Good Cause Shown" or other sufficient notice that the form is being filed in accordance with Notice 2012-21. If the executor of a qualifying estate already filed a late-filed estate tax return in hopes of preserving portability and the return was filed within 15 months of the decedent's death, an extension filed in accordance with the requirements of this Notice will relate back to the previously-filed return. However, no additional extension of time to file can be obtained after the 6-month extension, except in the case of an executor abroad.[5]

Temporary regulations,[6] which are also serving as proposed regulations, have been issued. These regulations address both the estate tax and the gift tax issues relating to portability. The regulations under Section 2010 are arranged so that Regulation Section 20.2010-1T provides definitions and applicable dates. Regulation Section 20.2010-2T addresses the portability issues as they apply to decedent's estates. Regulation Section 20.2010-3T discusses portability provisions that are applicable to the surviving spouse's estate. Regulation Section 25.2505-1T describes the general rule, special rules and applicable dates. Regulation Section 25.2505-2T explains the use of the DSUE amount by the surviving spouse for gift tax purposes.

In addition, a draft United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) was initially published in 2012, along with draft instructions. The key changes to Form 706 largely related to portability issues and contingent claims. Form 706 for decedents dying in 2012 was finalized after changes were made to correct the calculation of the DSUE amount in Part 6.[7] A draft Form 706 has been released for decedents dying in 2013 that provides for updates for inflation adjustments, increase in the tax rates and further refinements to the calculation of the DSUE amount.[8]

An updated United States gift (and Generation-Skipping Transfer) Tax Return (Form 709) was issued in 2012 as well to include a new section to provide information on any DSUE amount the taxpayer may have.[9] Updated instructions to the proposed Form 709 were also published.[10] The new draft of Form 709 for 2013 has not yet been published.

Let's take a look at the basics – the who, what, when, where and why – behind portability.

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WHO

Portability applies to the surviving husband or wife of a married couple.[11] A few definitions are important in determining the players involved.

"Last Deceased Spouse." The last deceased spouse means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."[12] Even if the surviving spouse remarries after the death of her deceased spouse, as long as the surviving spouse predeceases the new spouse, the deceased spouse is considered to be the last deceased spouse.[13] The determination of the last deceased spouse is not affected by the amount of any unused exemption amount or portability elections.[14] It is simply based on the facts existing at the time with respect to the relationship of the parties.

"Other Deceased Spouse." Although the "other deceased spouse" is not a defined term in the temporary regulations, that term is used to refer to a spouse who is not the last deceased spouse, but whose deceased spousal unused exclusion ("DSUE") amount was previously used by his or her surviving spouse for gifting purposes. A special rule applies in the case of multiple deceased spouses and such previously-applied DSUE amounts.[15] See the discussion of DSUE amount below.

"Non-US Citizens." Portability has limited availability to non-US citizens, depending on residency and citizenship.

If the deceased spouse is a nonresident, non-US citizen at the time of his or her death, a portability election is not available.[16] If the deceased spouse is a non-US citizen but is a resident at the time of his or her death, a portability election is available. However, the surviving spouse's use of that exemption may be limited or disallowed, depending on the surviving spouse's status.

For gift tax purposes, if, at the time of the gift, the surviving spouse is a nonresident, non-US citizen, he or she cannot utilize any of the deceased spouse's DSUE amount except to the extent allowed under an applicable treaty obligation of the United States.[17] For estate tax purposes, if, at the time of the surviving spouse's subsequent death, the surviving spouse is a nonresident, non-US citizen, he or she cannot utilize any of the deceased spouse's DSUE amount except to the extent allowed under an applicable treaty obligation of the United States.[18] Certain restrictions are imposed on qualified domestic trusts ("QDOTs") that are created on the deceased spouse's death for the benefit of a non-US citizen surviving spouse. See the discussion of special rules applicable to QDOTs below.

"Executor." Only the executor is able to make an election to take advantage of or opt out of portability.[19] Under the new regulations, an executor is defined as an administrator or executor "that is appointed, qualified, and acting within the United States, within the meaning of section 2203…."[20] In addition, if there is no such appointed executor or administrator, the regulations provide that "any person in actual or constructive possession of any property of the decedent (a non-appointed executor) may file the estate tax return on behalf of the estate of the decedent"[21] to elect portability or to elect not to have portability apply. These regulations mirror the provisions of Section 2203.

WHAT

There are several defined terms used in the determination of the amount of the deceased spouse's exemption amount that is eligible for portability.

"Basic Exclusion Amount." The basic exclusion amount is $5 million beginning in 2011, and is subject to inflation adjustment thereafter.[22] The basic exclusion amount for 2012 was $5.12 million and is $5.25 million in 2013.

"Applicable Exclusion Amount." The applicable exclusion amount is the sum of the basic exclusion amount and the deceased spousal unused exclusion amount (the DSUE amount).[23]

"Applicable Credit Amount." The applicable credit amount is the amount of tax that would be determined under section 2001(c) for estate or gift tax purposes on the applicable exclusion amount.[24] This amount is subject to reduction for certain pre-1977 gifts. The applicable exclusion amount is reduced by twenty percent of the total specific exemption amount that was allowed under section 2521 for gifts made after September 8, 1976 and before January 1, 1977.[25]

"Deceased Spousal Unused Exclusion (DSUE) Amount." The code defines the DSUE amount as:

> "DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT.—For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term 'deceased spousal unused exclusion amount' means the lesser of—
>
> (A) the basic exclusion amount, or
>
> (B) the excess of—
>
> (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
>
> (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."[26]

Prior to the publication of the temporary regulations and the legislative fix under ATRA, there was quite a bit of controversy over how the DSUE amount was calculated.[27] The confusion arose from the reference in the statute to the "basic exclusion amount" in section 2010(c)(4)(B)(i) instead of to the "applicable exclusion amount." There is quite a bit of discussion about this in the temporary regulations. Example 1 in temporary Regulation Section 20.2010-2T(c)(5) provides an example of how to calculate the DSUE amount based on their interpretation of the statute prior to the correction made under ATRA.

The temporary regulations also clarify that the basic exclusion amount referred to in Section 2010(c)(4)(A) means the amount in effect in the year of the decedent's death (as opposed to the year in which it is used).[28]

Prior Taxable Gifts. For purposes of computing the DSUE amount, the regulations provide that a special rule applies if the decedent made taxable gifts on which he or she paid gift tax. The amount of the adjusted taxable gifts of the deceased spouse is reduced by the amount of those gifts in making the DSUE amount calculation. This is an appropriate adjustment from a fairness standpoint. However, the statute does not provide for this adjustment. It appears that the Treasury and the Secretary are making this interpretation based on authority under Sections 2010(c)(6) and 7805. See Example 2 in temporary

Regulation Section 20.2010-2T(c)(5) for an example of how to calculate the DSUE amount where gift tax was previously paid by the deceased spouse.

Effect of Tax Credits. The temporary regulations do not address the order in which available credits are applied in computing the DSUE amount. At this point, it is unclear if the DSUE amount is calculated before or after the application of credits arising for taxes on prior transfers under Section 2013, foreign death taxes under Section 2014 and death taxes on remainders under Section 2015. ACTEC's comments in response to Notice 2011-82 briefly address this issue, requesting that the DSUE amount be calculated after taking into account any credits, so that the surviving spouse will receive the full benefit of the deceased spouse's unused exclusion amount.[29] This issue is still under consideration by the Treasury and the IRS and they have requested comments on this topic to assist in their analysis.[30] It is likely that guidance will be eventually published to address this issue. The temporary regulations reserve a section for this guidance.[31]

Special Rules Applicable to Qualified Domestic Trusts (QDOTs). If the deceased spouse creates a QDOT for the surviving spouse, the DSUE amount is calculated as described above. However, the initial DSUE amount is subject to adjustment in the future and the surviving spouse's use of the DSUE amount is restricted. The temporary regulations provide that the DSUE amount initially calculated at the deceased spouse's death is recalculated upon the final distribution or termination of the QDOT or the death of the surviving spouse who is the beneficiary of the QDOT.[32] This rule that suspends the surviving spouse's use of the deceased spouse's DSUE amount also applies to gifts, with one exception.[33] This exception allows the surviving spouse to apply the deceased spouse's DSUE amount to gifts made in the year of the surviving spouse's death or in the year that the terminating event occurs.[34] The regulations contain examples that explain how these provisions apply.[35] Treasury and the IRS received comments on this issue prior to the publication of the temporary regulations, but have requested additional comments on this topic.[36]

WHEN

In order to take advantage of portability, an election must be made on behalf of the decedent's estate. That election must be made on a timely-filed estate tax return (Form 706).[37] The temporary regulations make it clear that even though an estate tax return would not otherwise be required to be filed, if a portability election is desired, then the estate will be considered to be required to file a return under Section 6018(a).[38] The return will be considered timely-filed if it is filed within nine months after the decedent's death or within the amount of time provided in any extensions obtained from the IRS.[39] There are no provisions for a late-filed election.[40] If the estate cannot qualify for the automatic extension permitted under Notice 2012-21 discussed above, there may be no relief available for the failure to timely file. The general catch-all relief provisions under Regulation Section 301.9100-3 will not apply because this election is a statutory election.[41] The IRS's position is that they are not authorized to offer relief under Regulation Section 301.9100-3 for statutory elections (even if the election is also a regulatory election).[42] The relief provisions under Regulation Section 301.9100-2 allow extensions for certain statutory elections by allowing an automatic six-month extension from the original due date (without extensions) if the taxpayer timely filed its return but failed to make the election.[43] In the case of a portability election, it is not clear if this relief will be available. If the portability election is not made because no return was filed, relief is not available. Relief could potentially be available if the return was timely filed, but for some reason was incomplete or not properly prepared. In cases where the return was timely filed and the executor affirmatively stated it was not electing portability, it may be difficult to later request an extension of time to affirmatively make the election. The IRS may interpret the affirmative opting-out of portability as an election for purposes of 9100 relief, particularly because Form 706 requires the executor to check a box to opt out of the portability election.

Once made, the election is irrevocable.[44] If the executor makes an election on a return filed before the due date, and then files a subsequent return that indicates no election is made, as long as the subsequently filed return is timely it will supersede the previously-filed return.[45] However, as discussed above, there may be several people who are eligible to make the election in the case of an estate with no appointed executor. In the case of multiple "non-appointed" executors, whose election takes effect? It appears that it is the election that is made first. The temporary regulations provide that "[a] portability election made by a non-appointed executor cannot be superseded by a contrary election made by another non-appointed executor of that same decedent's estate (unless such other non-appointed executor is the successor of the non-appointed executor who made the election)."[46] Challenges may arise for any non-appointed executors who wish to make this election. If a non-appointed executor desires to make a portability election, he or she will need to gather sufficient information about the entire estate in order to file a complete return. However, if a non-appointed executor desires to opt out of making a portability election, it is not entirely clear that the return be a complete and properly-prepared return. The temporary regulations provide that an election will not be made if the executor either "…states affirmatively on a timely-filed estate tax return…that the estate is not electing portability…"[47] or fails to timely file an estate tax return.[48] Note that the words "complete and properly-prepared" are omitted from this section of the regulations. It could be argued that any return filed by a non-appointed executor to opt out of portability is sufficient for that purpose, even though it would not be considered sufficient to make the election.

The "complete and properly-prepared" requirement for the estate tax return is described in the temporary regulations.[49] As a general rule, the return will be deemed complete and properly-prepared if it is prepared in accordance with Form 706 instructions and the regulations under Section 6018.[50] However, some relaxed reporting requirements are provided under the temporary regulations if the return is not otherwise required to be filed, but is being filed to elect portability.[51] In these cases, there are special rules for valuing property that qualifies for the estate tax marital or charitable deduction. In most cases, the executor will only need to report the following information with respect to marital and charitable bequests, devises and transfers:

- Description, ownership and/or beneficiary of the qualifying property;
- Information necessary to establish that the property qualifies for the marital or charitable deduction; and
- An estimate of the total estate, including the qualifying property.[52]

The executor must include a best estimate of this property, rounded to the nearest $250,000.[53] The regulations remind the executor that this estimation is a part of the return that is signed under penalties of perjury.[54] The Form 706 provides that where this provision applies, the values for these estimated items are reported on a new line that is included in the recapitulation instead of being included on schedules A through I of the return, although a description of the property (without values) is still reported on the schedules. The examples in the temporary regulations are helpful in understanding the application of this special rule.[55]

The relaxed reporting rules do not apply to marital or charitable deduction property if one of the following applies:

- The value of the property relates to the value of property passing to another beneficiary of the estate;
- The value of the property is needed to determine the estate's eligibility special treatment such as alternate valuation, special use valuation or estate tax deferral;[56]
- Only a portion of the property includable in the estate qualifies for the marital or charitable deduction; or
- A partial qualifying terminable interest property election or a partial disclaimer is made with respect to the property. [57]

Computation Required. The temporary regulations require a computation of the DSUE amount to be made by the executor on the filed estate tax return.[58] Prior to the issuance of the new Form 706 in 2012, a complete and properly prepared estate tax return is deemed to be sufficient for this purpose.[59] The temporary regulations confirmed that this method of election was acceptable prior to the issuance of the new Form 706.[60] The regulations also clarify that executors who filed returns before the new form was available are not required to file a supplemental estate tax return using the revised form.[61] Many practitioners believe that it was advisable to make the calculation and provide an affirmative election on the estate tax return although it was not required. This is a practical approach that will make it apparent that the election was made and will clarify the amount of the DSUE amount available for the surviving spouse's use. The new Form 706 simplifies this calculation by providing the new Part 6, Portability of Deceased Spousal Unused Exclusion (DSUE).

Opting Out. Most of the emphasis in the temporary regulations has to do with an affirmative election to take advantage of portability. However, the regulations also clarify how to avoid or proactively avoid the election. The simplest way to avoid a portability election is to not file an estate tax return, provided that a return is not otherwise required to be filed.[62] If a return must be filed for other reasons, the executor must state affirmatively on the return or on a statement attached to the return that the estate is not electing portability under Section 2010(c)(5).[63] Form 706 for 2012 and the draft form for 2013 both provide a check box for the executor to elect out of portability.

Authority to Examine Returns. As provided in Section 2010(c)(5)(B), the IRS can examine the deceased spouse's estate tax return at any time – *even after the expiration of the statute of limitations with respect to the return itself* – in order to determine the proper DSUE amount that the surviving spouse is entitled to have available for his or her own use. Any materials that may be relevant to the calculation of the DSUE amount, including the estate tax returns of each deceased spouse, can be examined by the IRS for these purposes.[64] However, any adjustments from such examination can only result in additional estate tax in cases in which the statute of limitations for such assessment has not yet expired.[65] The IRS has indicated that an examination of an estate tax return will not be suspended merely because of a possible future review in connection with a portability election.[66] The IRS is currently issuing closing letters in estates in which a portability election has been made. These closing letters do not include any reference to the extended period of time allowed to review the return with respect to the portability election. These letters are also being issued fairly quickly – within three to four months after the estate tax return is filed. The IRS is also selecting estate tax returns that elect portability for audit as well, which may come as a surprise to some practitioners.

When the surviving spouse later dies, if he or she has a gross estate (increased by adjusted taxable gifts and the specific exemption amount) that is more than the basic exclusion amount, then the surviving spouse will have to file an estate tax return. This is true even if no tax will be due because of the use of the deceased spouse's DSUE amount. This will give the IRS the opportunity to review the valuations on the deceased spouse's estate tax return for purposes of challenging the DSUE amount calculated.

Attention should be given to this issue, particularly if there are previous spouses or blended families with respect to the estate. Those in control of the information with respect to the estate may not always be aligned or in communication with the surviving spouse. The surviving spouse will want to ensure that he or she has all of the relevant returns and documentation to support the DSUE amount from each predeceased spouse. Note that the temporary regulations provide that it is the surviving spouse's responsibility to substantiate the DSUE amount claimed on his or her return.[67]

Use of the DSUE Amount – Ordering. The temporary regulations provide a very generous approach to the use of the DSUE amount by the surviving spouse. Although the surviving spouse is entitled to only the DSUE amount of the last deceased spouse, special rules apply in cases of multiple deceased spouses and previously used DSUE amounts.

The first piece of good news is that generally the deceased spouse's DSUE amount is considered "available for use" by the surviving spouse as of the date of the deceased spouse's death, presuming a valid portability election is made on the decedent's estate tax return.[68] This clarification makes planning much simpler for the most part, as the surviving spouse can rely on the availability of the DSUE amount of a deceased spouse to offset any taxable gifts before having to use his or her own exemption amount without having to wait until an estate tax return is filed for the deceased spouse. Special rules apply when property passes to the surviving spouse in a QDOT, as discussed above.

The second bit of good news is that the deceased spouse's DSUE amount is applied to gifts of the surviving spouse before his or her own remaining exemption is used.[69]

The remaining good news is that a surviving spouse can take advantage of the DSUE amounts of multiple predeceased spouses during the surviving spouse's lifetime.[70] Thus, to the extent a surviving spouse can use the full amount of each predeceased spouse's DSUE amount before the next spouse's death, he or she can make gifts far in excess of the exemption amount. The surviving spouse must use these exemptions through lifetime gifting. Upon the surviving spouse's death, he or she is limited to only the last deceased spouse's DSUE amount.

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The election for portability is made by filing IRS Form 706. For deaths in 2011, a timely-filed estate tax return (Form 706) is sufficient to elect portability. As discussed above, an attachment to the return reflecting an affirmative election may be prudent even though not required.

For deaths after 2011, Form 706 has provisions specifically relating to the portability election. A new Part 6 has been added to compute the DSUE amount. The amount calculated on this schedule is carried forward to page one, where new lines 9a, 9b and 9c are added to compute the combined basic exclusion amount and DSUE amount. In addition, a new line 3b has been added to Part 4 that requires information about all prior marriages of the decedent. The name and social security number of each former spouse must be included in the part. In addition, the date each prior marriage ended and a description of whether the marriage ended by death, divorce or annulment must be included in this part as well. Finally, the recapitulation in Part 5 includes two new lines to reflect the estimated value of the assets that qualify for the relaxed reporting rules discussed above with respect to marital or charitable deduction property.

Part 6 contains the bulk of the portability provisions. It includes a box for the executor to check to opt out of the portability election. In addition, section B of this part requires the preparer to indicate whether or not assets of the estate pass to a QDOT. Section C provides the method for calculating the DSUE amount portable to the surviving spouse of the decedent, while schedule D provides a chart for calculating the DSUE amount the decedent received from prior predeceased spouses.

When the 2012 From 706 draft form was issued, there was an error in the calculation of the DSUE amount passing to the surviving spouse in section C. The calculation did not work correctly in cases in which gift tax had previously been paid and the decedent had entirely exhausted his or her applicable exclusion amount. In these situations, the calculations provided on the draft form resulted in a DSUE amount being increased by the amount of prior gifts on which gift taxes were paid, regardless of the taxability of the estate at the decedent's death. This calculation error was corrected on the 2012 Form 706 before it was issued in final form.

The surviving spouse will report the use of the deceased spouse's DSUE amount on lifetime gifts on a timely filed gift tax return (Form 709). The new form includes a box on new line 19 in Part 1 for the donor to check if he or she has applied a DSUE amount to the current or any prior gift tax return. There is also a new schedule C to calculate the total available DSUE amount. The total calculated on this new schedule C carries forward to the tax computation in part 2. Note that schedule C on Form 709 requires the donor to state whether or not a portability election has been made. Recall that the DSUE amount is available for use by the surviving spouse right away. There is no requirement to wait until the estate tax return is filed for the deceased spouse before using the DSUE amount. In situations in which the donor is required to file his or her gift tax return prior to the due date of the estate tax return of the deceased spouse (with extensions), it is unclear how the donor should complete this schedule. One option would be to file the return indicating that an election has been made, under the assumption that it will be made. Another option would be for the surviving spouse to leave the box blank, attach a statement indicating that the election will be made and take the deduction for the DSUE amount as if the election had already been made. Alternatively, a conservative alternative would be for the surviving spouse file the return indicating that the election has not yet been made although it is anticipated to be made, pay gift tax on any amount taxable without the use of the DSUE amount, then later file and amended return seeking a refund once election is made.

WHY

Many practitioners believe that portability is a good safety net for those who have not done any estate planning, but is not something they would recommend to their clients. However, portability has really opened up the landscape of estate planning options for couples at all wealth levels. First, let's take a look at some of the pros and cons of recommending or relying on portability versus the use of traditional bypass or credit shelter trust planning.

Pros: The main benefit of portability is its relative simplicity.

- Married couples who are not interested in spending money on comprehensive estate plans that include bypass trust planning may opt to rely on portability to shelter their combined estate from estate tax. In many cases, the average couple can title their probate assets as joint tenants with rights of survivorship. This may avoid the need for probate on the first spouse's death. Although the estate tax return filing requirement may create some additional complexity, the relaxed reporting requirements of the temporary regulations mitigate this burden to a certain degree.
- For married couples with one or more large qualified retirement accounts, relying on portability may be particularly desirable. Although a bypass trust that is drafted as a see-through trust can be named as the beneficiary of a retirement account without accelerating the income tax on the account, including the required provisions necessary to meet this requirement is not consistent with the traditional purposes of the bypass trust.[71]
- Married couples with disparate wealth may prefer to rely on portability than on lifetime equalization planning between the spouses. If one spouse's estate is nontaxable and the other spouse's estate exceeds the taxable limits, bypass trust planning is not effective for the "poorer" spouse. If the nonwealthy spouse dies first, his or her estate tax exemption will be lost without portability, even with bypass trust planning because he or she simply does not have enough money to fund the bypass trust.
- If the marital assets consist of low basis assets, portability may be a better option than traditional bypass planning in order to take advantage of the step-up in basis in assets at death. With the increase in income tax rates on capital gains and the relatively low estate tax rate, this is a good alternative in the right circumstances.

Cons: The most commonly discussed drawbacks include the following.

- Assets of the deceased spouse that pass outright to the surviving spouse are subject to creditors of surviving spouse, whereas if those same assets are transferred to a bypass trust they are more likely to be protected from creditors.
- Appreciation received from the deceased spouse's estate will be included in surviving spouse's estate. If proper bypass trust planning is implemented on the death of the first spouse, all of the appreciation from the assets transferred to the bypass trust that are not distributed to the surviving spouse during his or her lifetime should not be subject to estate tax at the subsequent death of the surviving spouse.

- There is a possibility that the deceased spouse's exemption amount could be lost entirely if the surviving spouse later remarries a new spouse and the new spouse predeceases the surviving spouse after using his or her entire exemption amount.
- Portability does not extend to the generation-skipping transfer ("GST") tax. Any amount of the GST tax exemption amount that was not used during the deceased spouse's life or through other planning at his or her death will be lost.
- Portability has not been adopted at the state level. Use of bypass planning may help mitigate state estate taxes that would be imposed on the presumably larger estate of the second spouse to die.

Aside from looking at just portability vs. bypass planning, practitioners also need to consider the broad planning opportunities and options available, taking into account the changes in the tax laws and each client's particular situation. There are several options in designing estate plans now that portability is an option that may be more beneficial than traditional bypass planning, particularly if a client has assets than are anticipated to appreciate at a rapid rate even after the first spouse's death. Alternatives include transferring all assets to a QTIP (qualified terminable interest) trust or leaving assets outright to the surviving spouse and providing for a "disclaimer" trust that can function as a bypass trust in the event the surviving spouse disclaims the outright ownership of the property at the first spouse's death but still wants to benefit from that property via trust distributions. If the QTIP trust is used, the executor can often be given the option to make a partial QTIP election or a special election called a "Clayton" election in order to use some or all of the deceased spouse's exemption amount. The benefit of this type of planning is that the decision about where the assets pass can be deferred until after the first spouse dies, instead of being locked into mandatory bypass trust funding at the date the planning documents are prepared. If the QTIP trust is used, a reverse QTIP election could be made to reduce the risk that the deceased spouse's GST tax exemption amount will be lost. It is important to keep in mind that if disclaimer planning is used, then the decision about funding will need to be made by the surviving spouse within nine months after the first spouse's death. However, with QTIP planning, the executor will have up to fifteen months to make a decision.

The best course will depend on a variety of factors that vary from client to client. Some of the factors to consider include asset composition, anticipated growth of assets, client age and health issues, blended family issues, desire for control, creditor issues, desire for simplicity/tolerance for complexity and income tax rates, among others. There will not be a "one-size-fits-all" solution for all clients. The one thing that does appear certain is that nearly all clients will benefit from a review of their estate plan.

CONFLICTS AMONG EXECUTORS AND BENEFICIARIES

The regulations make it clear that it is the executor who must make the election to take advantage of portability or to opt out of such election. Practitioners advising executors may find themselves in a dilemma if the deceased spouse's will does not address the issue (or if there is no will). In the typical long-term first marriage scenario in which all assets go to the surviving spouse and later pass to the couple's joint children, there may be no issues. However, a few scenarios come to mind that are not as simple. In situations where there are multiple beneficiaries with differing interests, the decision path may not be as clear.

Let's look at some examples.

Example 1. Suppose husband is married to his second wife and has two children from a prior marriage. Husband dies in 2011 with a taxable estate of $2 million. Husband's will provides that all of his assets pass to his children. No estate tax return is required to be filed, except to make the portability election. Let's assume that the wife is named as executor. The wife will have access to the information necessary to file the estate tax return to elect portability and will have the power to do so. Who bears the cost of the filing is another matter. Is it a proper expense of the estate or should the wife pay for the expense from her own personal funds? In independent estate administration, the independent executor may pay expenses of the estate without court approval.[72] In dependent administration, the personal representative is entitled to all necessary and reasonable expenses incurred in the management of the estate on satisfactory proof to the court.[73] Wife could reasonably make a claim that preparation of the estate tax return is in connection with the proper management of the estate.

Example 2. Let's change the facts in Example 1 slightly, so that the children of the prior marriage are the executors. Let's first presume that they don't mind filing the return, but don't want to bear the expense for filing. If the wife pays for the return preparation and then later makes a claim against the estate to recover the expense, should the children be required to pay for this as an administrative expense of the estate? It is likely that a few probate judges will get to weigh in on this issue.

Alternatively, what will occur if the children have no interest in filing a return to elect portability, because in addition to the cost, they don't want the liability related to filing an estate tax return? Can the surviving spouse compel the executors to file a return? If the surviving spouse is able to characterize the deceased spouse's DSUE amount as an asset of the estate or as a claim against the estate, there may be judicial relief available to the surviving spouse.[74]

Example 3. Let's use the same facts as in Example 2, and add the fact that husband and second wife are in the process of divorce? Assume the divorce is pending and would have been final a day after husband's death. Also assume that the divorce was highly disputed and children (who are the executors) are strongly opposed to providing any tax benefit to the divorcing wife. They want to withhold the tax benefit purely out of spite. Wife is willing to pay for the preparation of an estate tax return, but children refuse. What is the recourse for wife? Is she somehow entitled to the use of husband's unused exemption amount? Can the children prevent her use of this exemption?

Other circumstances may affect whether or not portability is elected. What happens in Example 3 if there is no executor appointed because there is no apparent need for a probate administration? Can the children, out of spite, apply to be appointed as executors even if an appointment is not strictly necessary, just to prevent surviving wife from being able to file an estate tax return to elect portability as a non-appointed executor? The children would have to show that a necessity exists for the administration of the estate.[75] However, that should normally not be too difficult to do given the many aspects the estate administration that rely on the powers granted to executors. If no executor is appointed, will there be a race between the surviving wife and the children to elect into or out of portability?

Example 4. Let's use the facts of Example 2 (children are the executors), but instead of the children being the beneficiaries of the estate, the sole beneficiaries are various charitable organizations. Should the charities bear the cost of the estate tax return preparation for the benefit of the surviving spouse?

ETHICAL CONCERNS

Taking a step back from the disputes among the parties, let's take a look at who is advising the executor. In many cases, the attorney who drafted the estate planning documents will be the attorney to represent the executor of the estate. The attorney will need to take care to ensure that he or she is not violating ethical rules. Below is Texas Disciplinary Rules of Professional Conduct Rule 1.06, Conflict of Interest: General Rule:

"(a) A lawyer shall not represent opposing parties to the same litigation.

"(b) In other situations and except to the extent permitted by paragraph (c), a lawyer shall not represent a person if the representation of that person:

"(1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interests of another client of the lawyer or the lawyers firm; or

"(2) reasonably appears to be or become adversely limited by the lawyers or law firm's responsibilities to another client or to a third person or by the lawyers or law firm's own interests.

"(c) A lawyer may represent a client in the circumstances described in (b) if:

"(1) the lawyer reasonably believes the representation of each client will not be materially affected; and

"(2) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.

"(d) A lawyer who has represented multiple parties in a matter shall not thereafter represent any of such parties in a dispute among the parties arising out of the matter, unless prior consent is obtained from all such parties to the dispute.

"(e) If a lawyer has accepted representation in violation of this Rule, or if multiple representation properly accepted becomes improper under this Rule, the lawyer shall promptly withdraw from one or more representations to the extent necessary for any remaining representation not to be in violation of these Rules.

"(f) If a lawyer would be prohibited by this Rule from engaging in particular conduct, no other lawyer while a member or associated with that lawyer's firm may engage in that conduct."

Most careful planners make it clear in their engagement letter for an estate that they are representing the executor. Some attorneys take the extra step to affirmatively state that they do not represent the beneficiaries. The comments to Rule 1.06 specifically state that with respect to estate administration, the lawyer should make it clear to the parties involved whether the fiduciaries or the beneficiaries are the clients.[76] This will become more important in estates in which election or nonelection of portability may become an issue. If the lawyer believes that a conflict may arise regarding the steps necessary to make the portability election (i.e., filing an estate tax return), the lawyer should be proactive in reminding the parties who he represents and who he does not represent with respect to the estate. In cases in which the lawyer has represented the entire family over a number of years, the beneficiaries may believe that the lawyer is still representing their interests even though the engagement letter states he is representing the executor. In these cases, an affirmative statement that the beneficiaries are not represented by executor's counsel and should seek their own counsel for assistance should be made.

ADVISING ISSUES

It is difficult to know how to advise those clients who forego the more complex bypass trust planning in favor of simplicity. It comes up often in estate planning for the wealthy. While a complex estate plan may make sense from tax savings perspective, clients often forgo planning opportunities that they perceive to be too complicated or outside the boundaries of their risk tolerance. When this happens, some practitioners may think "Belt." In the Belt case,[77] which received much publicity in estate planning circles, the Texas Supreme Court held that the executors of an estate could maintain a legal malpractice claim against the decedent's lawyers on behalf of the estate. Although the court did not find the lawyers liable for malpractice, the *Belt* case had many practitioners worried about future claims from heirs of clients who thought more aggressive planning could have been done to reduce estate tax liability. With the star witness to what was discussed dead, estate planning attorneys began preparing lengthy memos summarizing conversations with clients and letters to clients confirming that certain planning techniques were discussed and rejected by the client. Attorneys who prepare such memos and letters (and even ones who don't) should consider adding a new section about portability or creating a separate advisory memo.

Several other potential malpractice risks arise with portability. Advising clients whether it is prudent to forgo tax-planned wills in favor of relying on portability is one issue. Others include advising clients about requirements to make the election (timely filing of an estate tax return), requirements to keep documentation to support valuations until the second spouse's death and advising clients about the effects of subsequent marriages.

Changes in the law can certainly make the current ideal plan turn out to be not the best solution for the clients in the future. Although ATRA made the current estate, gift and GST tax exemption amounts (with inflation adjustments) and the tax rates permanent, the current administration's fiscal year end 2014 revenue proposals (as explained by the Treasury in what is popularly referred to as the "Green Book") includes a provision that would reduce the estate and GST tax exemption amount to $3.5 million (without increases for inflation adjustments in future years) and the gift tax exemption amount to $1 million beginning in 2018.[78] The proposal also includes an increase in the gift, estate and GST tax rate from 40% to 45%. Although the Green Book is just the President's "wish list" of fiscal policies that he would like to implement in the upcoming fiscal year, it is an indication that estate and gift taxes are still on the table for certain politicians in their quest to raise revenue.

In light of this uncertainty, some practitioners are taking steps to ensure their clients do not miss out on exemption in portability situations by failing to file a return. One way to influence clients whose spouses have died to file an estate tax return where there is any DSUE amount remaining is to explain that the cost of preparing the estate tax return is equivalent to the cost of purchasing an insurance policy against future estate taxes on the DSUE amount. The cost of preparing the return is your one-time premium payment for the policy. Another way to encourage clients to file an estate tax return to elect portability is to remind the

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surviving spouse that the detailed information that is included in the estate tax return, such as basis information, will be needed by the surviving spouse for his or her own tax purposes.

DRAFTING ISSUES

Estate Planning Documents. Practitioners may want to consider adding specific language in their wills with respect to the portability. Most lawyers will prefer to give broad discretion to the executor to elect or not elect. However, some thought should be given in directing how the incremental cost of making the election will be paid. A default provision could require that the election be paid for as an expense of the administration of the estate. However, in the second family situation, that might not be the best solution or one that your client would want. For those who have client questionnaires or a checklist of items to discuss with the client at the initial meeting, this should be one more item added to those lists.

Premarital Agreements. Practitioners should consider elections with respect to portability in marital property agreements. Particularly with respect to spouses with disparity in their wealth, the wealthier spouse may want to negotiate use of the poorer spouse's exemption amount should he or she predecease the wealthier spouse. It may be prudent to include each party's remaining exemption amount in the disclosure of assets. While it may be prudent to require a portability election to be made if the survivor requests it, practitioners may want to include a provision that confirms that neither party has a duty to preserve his or her exemption amount.

Family Settlements/Will Contests. Inevitably, there will be legal disputes over the portability of a deceased spouse's DSUE amount. Several of those scenarios are discussed above. Negotiating the use of a decedent's DSUE amount will likely be a negotiation factor in will contests as well. It will be important in those cases to keep in mind that the election must be made on a timely filed return. That could be a challenge in litigation situations.

CONCLUSION

Just a few years ago, the idea of portability seemed like a good way to allow married couples to enjoy the benefits of more complicated estate planning to preserve exemption without actually having to do the planning. Most practitioners agreed that it would be a good addition to current law. However, now that portability is available, it is not as simple as it once seemed. In reality, with the decisions that are required to be made and the technical requirements necessary to make the portability election, it appears that portability has created more work for attorneys rather than less. Taxpayers who otherwise would not have considered filing estate tax returns before portability now have to consider that option, and their advisors need to take the extra steps to ensure they fully understand those options. These are indeed exciting times to be an estate planning attorney!

[1] 58 Tax Law. 93, 200 (Fall 2004).
[2] I.R.S. Notice 2011-82, 2011-42 I.R.B. 516.
[3] *Id*. at 517.
[4] I.R.S. Notice 2012-21, 2012-10 I.R.B. 450.
[5] *See* Section 6081.

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[6] T.D. 9593, 2012-28 I.R.B. 54. Note that these temporary regulations are effective on June 15, 2012 and are set to expire on or before June 1, 2015. The temporary regulations also serve as the text for the proposed regulations. Prop. Treas. Reg. §§ 20.2001-2; 20.2010-0 to -3; 25.2505-0 to -2, 77 Fed. Reg. 36229 (June 18, 2012).

[7] The final Form 706 can be found at http://www.irs.gov/pub/irs-pdf/f706.pdf and the instructions to Form 706 for 2012 can be found at http://www.irs.gov/pub/irs-pdf/i706.pdf..

[8] The draft From 706 for 2013 can also be found at http://www.irs.gov/pub/irs-dft/f706--dft.pdf.

[9] The 2012 Form 709 can also be found at http://www.irs.gov/pub/irs-pdf/f709.pdf.

[10] The instructions to the 2012 Form 709 can be found at http://www.irs.gov/pub/irs-pdf/i709.pdf.

[11] Under the Defense of Marriage Act (Pub. L. 104-199, 110 Stat. 2419, enacted September 21, 1996, 1 U.S.C. § 7 and 28 U.S.C. § 1738C), marriage is defined as the legal union of one man and one woman for federal and interstate purposes. Thus portability, at this point in time, only applies to married spouses of the opposite sex. However, in the case of Windsor v. United States, 833 F. Supp. 2d 394 (S.D.N.Y 2012), the court held that this portion of DOMA is unconstitutional, resulting in the allowance of an estate tax marital deduction for a surviving same-sex spouse of a decedent, The Second Circuit affirmed the District Court's ruling. The U.S. Supreme Court granted certiorari in December 2012 and heard oral arguments on March 27, 2013. No ruling has been issued. The docket for this case can be found at http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/12-307.htm.

[12] Reg. § 20.2010-1T(d)(5). Unless otherwise indicated, all Section ("§") references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all Regulation Section ("Reg. §") references are to the Treasury regulations promulgated thereunder.

[13] Reg. §§ 20.2010-3T(a)(3); 20.2505-2T(a)(3).

[14] Reg. §§ 20.2010-3T(a)(2); 20.2505-2T(a)(2).

[15] Reg. §§ 20.2010-3T(b)(1)(ii); 20.2505-2T(c)(1)(ii).

[16] Reg. § 20.2010-2T(a)(5).

[17] *See* Reg. § 25.2505-2T(f); § 2102(b)(3). The application and analysis of those rules and any related treaties are outside the scope of this paper. For a list of the current gift and estate tax treaties, see http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estate-&-Gift-Tax-Treaties-(International).

[18] *See* Reg. § 20.2010-3T(e); § 2102(b)(3).

[19] § 2010(c)(5).

[20] Reg. § 20.2010-2T(a)(6)(i).

[21] Reg. § 20.2010-2T(a)(6)(ii).

[22] § 2010(c)(3); Reg. § 20.2010-1T(d)(3).

[23] § 2010(c)(2); Reg. § 20.2010-1T(d)(2).

[24] § 2010(c)(1); Reg. § 20.2010-1T(d)(1).

[25] Reg. § 20.2010-1T(b).

[26] § 2010(c)(4).

[27] For a brief summary of the issues, see T.D. 9593 at p. 20. For a more detailed discussion, see the American Bar Association's paper "Portability – Part One," prepared by the Estate and Gift Tax Committee of the ABA Tax Section (in coordination with other committees from the Real Property Trust and Estate Law Section), found at http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2012/heckerling_report_2012_portability_part_one.authcheckdam.pdf.

[28] Reg. § 20.2010-2T(c)(1)(i).

[29] *See* ACTEC letter to the IRS (Oct. 28, 2011), p. 17, which may be found at http://www.actec.org/Documents/misc/Radford_Comments_Notice_2011-82.pdf.

[30] T.D. 9593 at p. 21.

[31] Reg. § 20.2010-2T(c)(3).

[32] Reg. § 20.2010-2T(c)(4).

[33] Reg. § 25.2505-2T(d)(2).

[34] *Id*.

[35] *See* Reg. § 20.2010-2T(c)(5), *Example 3*; Reg. § 25.2505-2T(d)(2)(ii).

[36] T.D. 9593 at p. 24.

[37] § 2010(c)(5)(A); Reg. § 20.2010-2T(a)(1).

[38] Reg. § 20.2010-2T(a)(1).

[39] *Id*.

[40] § 2010(c)(5)(A); Reg. § 20.2010-2T(a)(1).

[41] The Section of Real Property, Trust and Estate Law of the American Bar Association has requested a legislative fix to this issue by writing to certain members of Congress. Their letter can be found at http://www.americanbar.org/content/dam/aba/administrative/real_property_trust_estate/government_submissions/2013_04_29_qtip_645_letter_to_congress_v1.authcheckdam.pdf.

[42] *See* Priv. Ltr. Rul. 201109012 (Nov. 15, 2010) (revoking previously granted relief granted with respect to a qualified terminable interest election); Reg. § 301.9100-1.

[43] Reg. § 301.9100-2(b). If relief is granted, certain corrective action and procedures must be filed. *See* Reg. § 301.9100-2(c) and (d).
[44] § 2010(c)(5)(A); Reg. § 20.2010-2T(a)(4).
[45] Reg. § 20.2010-2T(a)(4).
[46] *Id*.
[47] Reg. § 20.2010-2T(a)(3)(i).
[48] Reg. § 20.2010-2T(a)(3)(ii).
[49] Reg. § 20.2010-2T(a)(7).
[50] *Id*.; Reg. §§ 20.6018-2 (relating to persons required to file a return), 20.6018-3 (relating to required contents of the return), 20.6018-4 (relating to documents to accompany a filed return).
[51] Reg. § 20.2010-2T(a)(7)(ii).
[52] *Id*.
[53] Reg. § 20.2010-2T(a)(7)(ii)(B).
[54] *Id*.
[55] *See* Reg. § 20.2010-2T(a)(7)(ii)(C).
[56] It's not clear how estate tax deferral would ever be a factor in an estate electing portability.
[57] Reg. § 20.2010-2T(a)(7)(ii)(C).
[58] Reg. § 20.2010-2T(b)(1).
[59] I.R.S. Notice 2011-82, 2011-42 I.R.B. 516, 517.
[60] Reg. § 20.2010-2T(b)(2).
[61] *Id*.
[62] Reg. § 20.2010-2T(a)(3)(ii).
[63] Reg. § 20.2010-2T(a)(3)(i).
[64] T.D. 9593 at p. 22; Reg. § 20.2010-2T(d).
[65] T.D. 9593 at p. 23; § 6501.
[66] T.D. 9593 at p. 23.
[67] Reg. § 20.2010-3T(c)(1)(iii).
[68] T.D. 9593 at p. 21; Reg. § 20.2010-3T(c)(1); Reg. § 25.2505-2T(d)(1).
[69] Reg. § 25.2505-2T(b).
[70] Reg. § 25.2505-2T(c).
[71] For an excellent summary and discussion of the issues relating to naming trusts as beneficiaries of qualified retirement plans, see Karen S. Gerstner, "Current Issues Related to Estate Planning with Qualified Retirement Plans and IRAs," which was presented at the State Bar Advanced Estate Planning And Probate Course, June 28, 2012. It can be found at http://www.texasbarcle.com/Materials/Events/9220/144091.pdf.
[72] Tex. Prob. Code § 145B.
[73] Tex. Prob. Code § 242.
[74] A discussion of the available remedies, such as temporary restraining orders, removal of the executor and criminal sanctions, are beyond the scope of this paper. For additional information on these remedies, see Mary C. Burdette, "Enforcing Beneficiaries' Rights," found at http://ccba.willsandprobate.com/Handouts/3-11-11%20Burdette%20outline.pdf.
[75] Tex. Prob. Code § 82(h).
[76] Texas Disciplinary Rules of Professional Conduct, Comment 15 to Rule 1.06.
[77] *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.*, 192 S.W.3d 780 (Tex. 2006). Also available on line from the Supreme Court of Texas website at http://www.supreme.courts.state.tx.us/historical/2006/may/040681.htm. An attorney who worked on this case indicated that it later settled.
[78] See the Department of Treasury's General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals at p. 138. The Green Book can be located at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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State Bar of Texas Tax Section
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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide Dan and Marty the opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to the three of us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and Dan is just irresponsible.

I. ACCOUNTING

A. Accounting Methods

1. Rev. Proc. 2012-39, 2012-41 I.R.B. 470 (9/4/12). The IRS announced a change in its policy on automatic accounting method changes in corporate reorganizations. Taxpayers that engage in a tax-free reorganization or liquidation under § 381(a) after 8/31/11 will be allowed to make automatic accounting method changes in the tax year they engage in the transaction. This revenue procedure clarifies and modifies (i) Rev. Proc. 2011-14, 2011-1 C.B. 330; and (ii) Rev. Proc. 97-27, 1997-1 C.B. 680, *as amplified and modified by* Rev. Proc. 2002-19, 2002-1 C.B. 696, *as amplified and clarified by* Rev. Proc. 2002-54, 2002-2 C.B. 432, *as modified by* Rev. Proc. 2007-67, 2007-2 C.B. 1072, *as clarified and modified by* Rev. Proc. 2009-39, 2009-2 C.B. 371, and *as clarified and modified by* Rev. Proc. 2011-14.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. **The IRS cuts an illegal drug dealer a break not warranted on the face of the statute.** Olive v. Commissioner, 139 T.C. No. 2 (8/2/12). The taxpayer operated a medical marijuana business that sold medical marijuana at retail under the California Compassionate Use Act of 1996. The Tax Court (Judge Kroupa) upheld the IRS's determination that the taxpayer underreported his gross receipts and that § 280E precluded his deduction of business related expenses. The IRS conceded that § 280E did not bar a deduction from gross receipts for costs of goods sold but argued that the taxpayer's ledger entries were inadequate substantiation and that as a factual matter cost of goods sold should be zero. Judge Kroupa sustained the IRS's position that the journal entries were unreliable, but applied *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) to find, based on expert witness testimony, that the cost of goods sold was approximately 75 percent of the gross receipts and adjusted that amount to account for marijuana that was given away to customers and staff. Judge Kroupa rejected the taxpayer's argument that the expenses should be deductible based on *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), in which the Tax Court held that the corporation's care-giving activities for terminally ill patients were a separate trade or business from its medical marijuana delivery and that expenses allocable to the care-giving activity were deductible as ordinary and necessary business expenses. In the instant case, unlike in *Californians Helping to Alleviate Medical Problems*, based on the facts and circumstances there were not two separate and distinct activities. In this case the taxpayer operated a single business of dispensing medical marijuana, with all other services being provided as part of that business.

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

- A straightforward reading of § 280E and the last sentence of § 263A(a)(2) in concert clearly denies the recovery of cost of goods sold for the marijuana in this case. Prior to the enactment of the last sentence of § 263A(a)(2), however, § 280E alone did not deny drug dealers tax-free recovery of the cost of goods sold. *See, e.g.*, *Franklin v. Commissioner*, T.C. Memo. 93-184. In *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), the IRS, based on that outdated case law conceded – erroneously in our opinion – that § 280E did not operate to deny as matter of law the cost of goods sold to a taxpayer that purchased and resold marijuana. That mistake was repeated in this case.

2. Abracadabra: A creditor's bad debt does not necessarily create debtor's COD income. Abarca v. Commissioner, T.C. Memo. 2012-245 (8/27/12). The Tax Court (Judge Goeke) held that no cancellation of debt income was realized by a taxpayer where the only evidence that the debt was discharged was a letter stating that the loan had been "charged off," but also stated that the taxpayer "still remain[ed] obligated for the repayment of the debt," and no Form 1099-C was introduced into evidence.

3. The fabled Plotkin diamond always comes with a curse – Mr. Plotkin. Plotkin v. Commissioner, 110 A.F.T.R.2d 2012-6752 (11th Cir. 11/27/12). Taxpayer received an economics degree from the University of Pennsylvania's Wharton School, class of 1963, and a law degree from St. Louis University, class of 1972, before he purchased a controlling interest in a nursing home empire from the father of his ex-wife in 1980. As the result of a complex series of financial machinations and fund diversions through his girlfriend(s) during the years 1991, 1992 and 1993, he was convicted on three counts of willfully making and subscribing false income tax returns under § 7206(1) in 1999 and sentenced to five years of probation. The Commissioner determined that he failed to report in excess of $1.5 million of Schedule C self-employment income during the years 1991 through 1995. In this unpublished per curiam opinion, the Eleventh Circuit affirmed a Tax Court decision upholding the Commissioner's determination, finding taxpayer's argument that he received non-taxable partnership distributions not supported by the facts because taxpayer deliberately chose not to be a partner in the entity from which he received financial benefits.

4. No COD from collateralized welfare benefit fund borrowing. Pinn v. Commissioner, T.C. Memo. 2013-45 (2/11/13). The taxpayer brothers were sole-shareholders and employees of their home construction company. The taxpayers caused the corporation to appoint Local 707 of the National Production Workers Union (of which four office employees became members) to facilitate the creation of an employee death benefit arrangement in which the taxpayers as owner/employees were allowed to participate. The union set up the American Fund as a voluntary employees beneficiary association (VEBA) which provided a trust for guaranteed death benefits. The trust funded several million dollars of death benefits by purchasing life insurance policies. The cost was paid with deductible expenses by the taxpayers' corporation. Each of the taxpayers then borrowed $500,000 as a hardship loan, justified by them because of unexpected taxes. The loans were repayable with annual $50,000 quarterly payments plus interest, or as a reduction in death benefits. No payments were made. At the insistence of its impendent accountant, the trust reported the loans in 2002 on a schedule to its form 5500 as in default or uncollectable. The Tax Court (Judge Holmes) rejected the IRS assertion that the taxpayers recognized COD income in 2002. The court concluded that the loans remained collectable from the taxpayers' death benefits with the insurance policies provided as collateral. The court rejected the IRS argument that the insurance policies were insufficient because they were owned by the trust, not the taxpayers. The court observed that, "It follows that if a reduction in the Pinns' death benefits or capture of insurance proceeds owed (in some way) to them is an adequate alternative form of repayment, there should be no COD income just because the Pinns failed to make their quarterly payments—any more than we would find COD income only because a homeowner stopped making payments on a $50,000 mortgage secured by a house worth a million." The court held further that, when a debt is collectible and fully secured (where the fair market value of the collateral exceeds the loan balance), default alone will not result in COD income." The court also observed that the trust could collect the full value of the loans with a reduction in the taxpayers' death benefits.

B. Deductible Expenses versus Capitalization

1. Temporary and proposed regulations provide extensive rules for the acquisition, production, or improvement of tangible personal property. T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The Treasury Department has promulgated temporary regulations, generally effective for tax years beginning on or after 1/1/12, addressing capitalization requirements for expenditures to acquire and improve tangible property. The temporary regulations adopt provisions of regulations proposed in 2008 (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 F.R. 12838 (3/10/08)), which were in turn based on a 2006 proposal that was substantially modified by the 2008 proposed regulations (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06)). The temporary regulations provide detailed capitalization rules and several bright-line standards under §§ 162(a) and 263(a) regarding the acquisition, improvement, or repair of tangible real and personal property. The temporary regulations also revise rules under § 168 regarding disposition and maintenance of general asset accounts for MACRS property. In general, the regulations adopt the provisions of the 2008 proposed regulations, but with multiple modifications. Temp. Reg. § 1.263(a)-2T provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3T provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules. The temporary regulations define material and supplies to treat as deductible (1) the cost of any property with a useful life that does not exceed one year and (2) any item that cost not more than $100. They add a book-conformity de minimis rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The temporary regulations contain provisions defining a unit of property as a key concept and address capitalization of expenditures that improve or restore a unit of property. The regulations do not provide for a detailed repair allowance rule, but do provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations. Rev. Proc. 2012-19, 2012-14 I.R.B. 689 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp Reg. §§ 1.162-3T and -4T (materials and supplies), 1.263 (a)-1T (capital expenditures in general), 1.263 (a)-2T (transaction costs), and 1.263(a)-3T (improvements), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). These changes are for taxable years beginning on or after January 1, 2012.

b. LB&I provides guidance under Rev. Proc. 2012-19. LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance announcing that pending final regulations will apply only in years beginning in 2014 and thereafter. Notice 2012-73, 2012-51 I.R.B. 713 (11/20/12). The IRS announced that pending final regulations will apply to taxable years beginning on or after 1/1/14, but that taxpayers will be permitted to apply the final regulations to taxable years beginning on or after 1/1/12. The notice also indicates that the temporary regulations may be revised with respect to the de minimis rule of § 1.263(a)-2T(g); dispositions under §§ 1.168(i)-1T and 1.168(i)-8T;

and the Safe Harbor for Routine Maintenance under § 1.263(a)-3T(g).

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

> [T]he IRS and the Treasury are concerned that taxpayers are expending resources to comply with temporary regulations that may not be consistent with forthcoming final regulations.

e. **This announcement amends — really!!??** Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). An announcement amending regulations — the temporary regulations (T.D. 9564), regarding the deduction and capitalization of expenditures under §§ 162(a) and 263(a) relating to tangible property to apply to taxable years beginning on or after 1/1/14, while permitting taxpayers to apply the temporary regulations for taxable years beginning on or after 1/1/12, and before the applicability date of the final regulations.

f. **A minor fix.** Ann. 2013-4, 2013-4 I.R.B. 440 (1/18/13). The IRS corrected the temporary regulations to provide in § 1.168(i)-l(*l*)(2) rules for making general asset account elections on Form 4562. The amendment corrects paragraph numbering mistakes.

2. **Avoided interest attributable to associated property taken out of service requires capitalization under *Chevron*-tested regulations that barely survive.** Dominion Resources, Inc. v. United States, 97 Fed. Cl. 239 (2/25/11). The taxpayer, an electric utility, removed boilers from service to replace burners. Reg. § 1.263A-11(e)(1)(ii)(B) requires that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements. The court (Judge Lettow) rejected the taxpayer's arguments that (1) the associated property rule of Reg. § 1.263A-11(e)(1)(ii)(B) is invalid as inconsistent with § 263A, and (2) it was adopted in contravention of the requirements of the Administrative Procedure Act. Under the test of *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the taxpayer argued that the regulation was inconsistent with § 263A(f)(2)(A)(ii), which provides that for purposes of determining production period interest "with respect to any property . . . interest on any . . . indebtedness [not directly attributable to production expenditures] shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures . . . had not been incurred." The taxpayer asserted that "property" for this purpose under the statutory language can include only the improvement itself, which is separately depreciable, and cannot, therefore be expanded to include associated property as provided in the regulation. The taxpayer also argued that the production costs were incurred with respect to the replacement burners, and not with respect to the boilers themselves. While the court was not completely happy with the IRS's argument that the property can be separated for depreciation purposes while considered as a unit for purposes of the interest allocation, the court concluded that the statute was sufficiently ambiguous under the first prong of the *Chevron* test that the regulation could be tested under the second prong of *Chevron*, which asks whether the regulation is a permissible construction of the statute. Here the court indicated that, "It is stretching the statute quite far to say that the associated-property rule 'is a reasonable interpretation of the enacted text' [of section 263A]." The court added that the IRS's rationales "are not very satisfying." The court then concluded, however, that "it is not this court's province to be making such policy choices. In this very close case, the court cannot say that Treasury overstepped the latitude granted by the statute to adopt regulations prescribing the calculation of interest to be capitalized in connection with an improvement to existing property used by the taxpayer to produce income" and held that the regulation therefore survived the taxpayer's challenge. With respect to the taxpayer's challenge under the Administrative Procedure Act, the court again found that "it is a stretch to conclude that Treasury 'cogently explain[ed] why it has exercised its discretion in a given manner,'" but added that "[t]he 'path' that Treasury was taking in the rulemaking proceedings can be 'discerned,' albeit somewhat murkily" and upheld the regulation. Finally, the court rejected retroactive application of a de minimis rule of Reg. § 1.263A-11(e)(2) to the taxpayer, and denied the IRS's counterclaim for capitalization of additional interest.

- No pretzel in existence has as many twists and bends as does this opinion.

a. But the regulation does not survive *Chevron* analysis on appeal. Dominion Resources, Inc. v. United States, 681 F.3d 1313 (Fed. Cir. 5/31/12). The Court of Appeals for the Federal Circuit (in an opinion by Judge Rader) reversed the Court of Federal Claims decision upholding Reg. § 1.263A-11(e)(1)(ii)(B), which requires that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements, by invalidating the regulation under step two of the *Chevron* analysis. The majority of the Federal Circuit panel held that "the regulation is unreasonable in defining 'production expenditures' to include the adjusted basis of the entire unit," because "[t]he regulation directly contradicts the avoided-cost rule that Congress intended the statute to implement." The opinion illustrated the problem with the following example.

> For example, let's say an owner purchased real property for $100,000 by a loan with a 3% interest rate. A few years later, she made an improvement that cost $5,000. If she had used that $5,000 toward the debt instead of the improvement, she would have avoided accruing $150 in interest ($5,000 multiplied by 3%). The avoided-cost rule requires her to capitalize that $150 in interest. The Treasury regulation, however, requires her to capitalize $3,150 in interest ($100,000 + $5,000 then multiplied by 3%). That result makes no sense, because there is no way that she could have avoided accruing $3,150 in interest by not making the improvement, as she did not expend or incur an amount equal to $105,000 when making the improvement.

- The court went on to point out that "[t]he only way that an amount equal to the adjusted basis could potentially satisfy the avoided-cost method is by assuming that the property owner would have sold the unit and used the sale proceeds to pay down the debt." Based on this analysis the Court of Appeals concluded that the Court of Federal Claims erred by concluding that the regulation reflected a "policy choice" by the agency and was thus permissible.

- The majority also invalidated the regulation, as did the concurring opinion of Judge Clevenger, on the basis that it violated the requirement imposed by the Supreme Court in *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), that the agency must provide a reasoned explanation for adopting a regulation. *"State Farm* requires that the Treasury 'articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made.'" Neither the preamble to the proposed regulations nor the preamble to the final regulations (nor Notice 88-99, 1988-2 C.B. 422) provided any rationale for adopting the rule in the regulations; there was "no explanation for the way that use of an adjusted basis implements the avoided-cost rule."

3. Proposed regulations restrict negative numbers in allocating indirect costs under the complicated "simplified methods rules." REG-126770-06, Allocation of Costs Under the Simplified Methods, 77 F.R. 54482 (9/5/12). Section 263A requires capitalization of all direct and indirect costs into goods produced during the year and inventory, so-called § 471 costs that must be included in inventory. Section 263A costs may be allocated on a facts and circumstances basis, or the taxpayer may use the simplified resale or simplified production methods provided in Reg. §§ 1.263A-2(b) and 1.263A-3(d) to allocate costs to eligible property produced or held for resale in lieu of a facts-and-circumstances allocation method. Under the simplified method a pool of additional capitalized § 263A costs (indirect costs not otherwise includible in inventory under the taxpayer's method of accounting) may be allocated among ending inventory and costs of goods sold based on an "absorption ratio" of such costs to the taxpayer's total § 471 inventory costs. In some circumstances the simplified method will produce negative amounts that cause distortions in inventory accounting, generally when a taxpayer capitalized a cost as an inventory cost that is greater than the amount required to be capitalized for tax purposes. Proposed Reg. § 1.263A-2(b) would, with certain exceptions, prevent taxpayers from using negative amounts in determining additional § 263A costs. Producers with average annual gross receipts of less than $10,000,000 would be allowed to continue to include negative amounts in additional § 263A costs. Retailers who use the simplified resale method would be permitted to remove inventory costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional § 263A costs.

- The proposed regulations include a modified simplified production method that would allow producers to separately determine the allocation of preproduction related additional § 263A costs using a preproduction cost absorption ratio applied to capitalized inventory costs for raw materials.

- As a sop for simplification, the proposed regulations would redefine a taxpayer's "additional § 263A costs" for purposes of the simplified methods as costs, other than interest, that a taxpayer capitalized to its inventory in its financial statements. The definition would provide, however, that a taxpayer must include all direct costs in its § 471 costs regardless of the taxpayer's treatment of the costs in its financial statements.

4. Tax expenditures for movies and television. The Compromise Tax Relief Act of 2010, § 744, extends the election under Code § 181 to expense up to $15 million of qualified film and television production costs if 75 percent of total compensation is for services performed in the U.S. The limit is $20 million for production costs incurred in low-income or distressed communities through 2011.

a. Final regulations come out just in time for the expiration date of the statute. T.D. 9551, Deduction for Qualified Film and Television Production Costs, 76 F.R. 60721 (9/30/11). Section 181 provides for an election to deduct qualified film or television production costs incurred in productions commenced prior to 1/1/12, as an expense not chargeable to capital account in an amount up to $15 million for each production, or $20 million for production expenses incurred in certain low income or distressed county areas. A production qualifies for the election if at least 75 percent of the total compensation for the production is for services performed in the United States by actors, directors, producers, and production personnel. Final regulations §§ 1.181-1 through -6, replacing temporary and proposed regulations, clarify the owner of production costs, the definition of aggregate production costs for purposes of the election and limitations, and provisions applicable to participations and residuals.

b. Temporary and proposed regulations update the rules. REG-146297-09, Deduction for Qualified Film and Television Production Costs, 76 F.R. 64879 (10/19/11). The temporary (Reg. §§ 1.181-0T, 1.181-1T) and proposed regulations clarify that the $15 million (or $20 million) limitation under amendments to § 181 applies to limit the aggregate deduction for production costs paid or incurred by all owners of a qualified film or television production for each qualified production, rather than limit the aggregate production costs.

c. And now, "final" final regulations after the provision expired. T.D. 9603, Deduction for Qualified Film and Television Production Costs, 77 F.R. 72923 (12/7/12). The final regulations (Reg. §§ 1.181-0, 1.181-1) remove the temporary regulations, and provide that whether production costs qualify for pre- or post-1/1/08 limitations, compensation to actors is allocated to first unit principal photography.

d. Thank Dodd that special expensing rules for film and television productions were extended to 2012 and 2013. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 317, extends through the end of 2013 the election under Code § 181 to expense up to $15 million of qualified film and television production costs if 75 percent of total compensation is for services performed in the U.S.

- The limit is $20 million for production costs incurred in low-income or distressed communities. Are any members of the film crew residents of those communities?

5. Law firm advances of litigation expenses were loans, not deductible expenses. Humphrey, Farrington & McClain v. Commissioner, T.C. Memo. 2013-23 (1/17/13). The cash method taxpayer plaintiff's law firm maintained a classification system for litigation costs advanced to clients in contingent fee cases. If the firm considered the likelihood of reimbursement to be high, the advanced costs were capitalized. In riskier cases where the firm considered the likelihood of reimbursement to be low, the firm deducted the advanced expenses, and reported reimbursement as income as advances were repaid. The Tax Court (Judge Morrison) held that the advanced litigation costs were loans in all cases, even if eventual recovery of the advances was contingent, and disallowed the deductions. The court found that there was a significant possibility of reimbursement, a factor that supported treating the advances as loans. The court also agreed with the IRS that the treatment of the advances as loans was a change in the taxpayer's method of accounting, which did not clearly reflect income, and, therefore, allowed adjustments under § 481 with respect to prior years. Nonetheless, the court found that the taxpayer's classification method was a reasonable attempt to ascertain the tax treatment of advanced expenses which qualified for the reasonable cause exception to § 6662 penalties.

6. Protecting directors from cement shoes in a shareholder class-action arising from a merger subject to capitalization. Why apply modern regulations when old case law will do the trick? Ash Grove Cement Company v. United States, 111 A.F.T.R.2d 2013-767 (D. Kan. 2/6/13).). The taxpayer settled a class action lawsuit by minority shareholders against itself and its directors arising out the acquisition of another corporation in a reorganization. The District Court (Judge Murguia) granted summary judgment for the government, holding that both the settlement payment and litigation expenses incurred by the taxpayer in resolving the class action lawsuit were capital expenditures under § 263. The origin of the claim for which the taxpayer incurred the expenses arose from a capital transaction. Even though the payments related to the taxpayer's 2005 return, the court applied the case law based "origin of the claim" test, *e.g.*, *Woodward v. Commissioner*, 397 U.S. 572 (1970), rather than Reg. § 1.263(a)-5, which was promulgated in 2003. The court held that the litigation expenses arose out of the acquisition transactions and were thus capital expenses under the origin of the claim test. The court rejected the taxpayer's argument that expenses incurred to indemnify directors from legal claims were deductible. The court pointed out that under the taxpayer's approach, "companies could always deduct litigation expense any time a director acting in good faith is sued in connection with a capital transaction so long as the company has an indemnity obligation."

7. With global warming these plants are growing faster. Notice 2013-18, 2013-14 I.R.B. 742 (2/19/13); Rev. Proc. 2013-20, 2013-14 I.R.B. 744 (2/19/13). The IRS has revised the categories of "berries" as plants that do not have a pre-productive growth period in excess of two years to segregate blueberry, blackberry, and raspberry plants, and removed papaya plants from the list. Under § 263A(d)(1) and Reg. § 1.263A-4(d) farmers who are not required to use the accrual method of accounting (and who are not tax shelters) are not required to capitalize the costs of raising animals or the costs of producing plants with a pre-productive period of two years or less. The IRS maintains a list of qualifying plants based on the nationwide pre-productive period for plants. The accompanying revenue procedure provides procedures for a taxpayer to obtain automatic consent to not apply § 263A to the production of plants removed from the list of plants that have a nationwide weighted average pre-production period in excess of two years.

C. Reasonable Compensation

1. Non-limit limitations on excessive compensation to corporate officers. REG-137125-08, Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 76 F.R. 37034 (6/24/11). Section 162(m) limits deductions for compensation to top corporate officers of publicly traded corporations to $1 million with an exception to performance-based compensation attributable to stock options and stock appreciation rights. Proposed regulation § 1.162-27(e)(2)(iv) would require that performance-based compensation plans designate the maximum number of shares with respect to which options or rights may be granted to an individual employee during a specified period. The preamble to the proposed regulations indicates that the IRS rejects assertions that specifying a limit is not necessary because such plans require shareholder approval as contrary to its interpretation of legislative history as requiring an objective formula for determining the maximum amount of compensation an employee could receive if the employee's performance goal is met.

a. Performance-based compensation is based in part on performance. Rev. Rul. 2012-19, 2012-28 I.R.B. 16 (6/25/12). The limitation of § 162(m) on deduction of employee compensation to an applicable employee by a publically held company to $1,000,000 does not apply to performance-based compensation. The IRS rules that a corporate plan to pay dividends and dividend equivalents on restricted stock granted to an employee that vests on meeting performance goals is performance based compensation. However, dividends and dividend equivalents payable on restricted stock regardless of whether the employee meets performance goals does not qualify as performance-based compensation. The ruling cites Reg. § 1.162-27(e)(2), which provides that performance-based compensation must be paid solely on account of pre-established performance goals based on an objective standard, on a grant-by-grant basis.

2. Every time a reasonable compensation case is appealable to the Seventh Circuit, it seems that whoever the judge is, after doing the *Exacto* bit to satisfy Judge Posner, he or she adds something like, "and in any event it wasn't deductible because it wasn't intended to be compensation." Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, T.C. Memo. 2011-74 (3/31/11). The taxpayer, an accounting and consulting firm operating as a C corporation, made payments to three related entities owned by the three named principals of the corporation that essentially resulted in zeroing out the taxpayer's income for the year. The related entities performed no services for the taxpayer, and at trial the taxpayer claimed that the payments were deductible as compensation to the named principals, who did perform services for the taxpayer. The court (Judge Morrison) held that even if the payments were viewed as compensation to the named principals, the payments were not deductible. Applying the "hypothetical independent investor" test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), because the case was appealable to the Seventh Circuit, Judge Morrison found that the rate of return on the firm's equity was "too low to create a presumption that the amounts claimed as 'consulting fees' were reasonable compensation for the [principals'] services." Because the taxpayer presented no other relevant evidence that the payments were reasonable in amount, the deduction was disallowed. Judge Morrison added that besides being reasonable in amount, to be deductible the payment must be intended to be compensation, and the payments in question were not intended to be compensation.

> [The firm] intended for the payments to the related entities to distribute profits, not to compensate for services. . . . Salvador chose the amount to pay each year so that the payments distributed all (or nearly all) accumulated profit for the year. He did this

for tax planning purposes. Each [principal's] percentage of the payments to the related entities was tied to hours worked, but the firm's intent in making the payments was to eliminate all taxable income. The firm did not intend to compensate for services.

- Accuracy related penalties were upheld, with Judge Morrison taking special note of the fact that the taxpayer was an accounting firm.

a. And Judge Posner agrees adding "[t]hat an *accounting* firm should so screw up its taxes is the most remarkable feature of the case." Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (7th Cir. 5/17/12). The Seventh Circuit (Judge Posner) affirmed the Tax Court, holding that the consulting fee payments to the three related entities owned by the three named principals of the C corporation, did not constitute deductible compensation but, instead, constituted a return on invested capital, i.e., dividends. This is because the taxpayer corporation was not "a pane of glass" between the billings of a typical small professional services firm and the salaries of its professionals where the amount of capital invested is negligible. Here, the taxpayer corporation had 40 employees in multiple branches, so the amount of invested capital was relatively large, and the consulting fees constituted a return on that invested capital. Judge Posner noted that treating the consulting fees as salary expenses, which reduced the firm's return to equity to zero even though the firm was "doing fine" flunked the independent-investor test.

- During the course of the opinion, Judge Posner managed to chide taxpayer's lawyers for "appear[ing] not to understand the difference between compensation for services and compensation for capital." He also chided taxpayer's expert witness for using "firm income per partner" of comparable accounting firms without "divid[ing] firm income per partner into salary and dividend components," which rendered his testimony "irrelevant."

- Judge Posner noted his "puzzlement" that the firm did not organize as a pass-through entity, but noted that it had to accept the consequences of its entity choice, "that in this case include[d] a large tax deficiency and a hefty penalty."

- See, *Pediatric Surgical Assocs., P.C. v. Commissioner*, T.C. Memo. 2001-81 (relating to the non-deductibility of compensation paid to shareholder employees derived from earnings resulting from the efforts of non-shareholder professionals).

- Shades of *Charles McCandless Tile Service v. United States*, 191 Ct. Cl. 108, 422 F.2d 1336 (Ct. Cl. 1970). It held that 15 percent of profits (before stockholders' salaries) should be considered as a dividend, and should reduce the deduction for salaries paid accordingly. That case aroused a great deal of interest when it first came out, and led to all sorts of closely held corporations paying out dividends of about $1,000 per year to establish a history of paying dividends.

3. You can save the failing nursing home, but don't pay yourself too much. Thousand Oaks Residential Care Home I, Inc. v. Commissioner, T.C. Memo. 2013-10 (1/14/13). The husband and wife shareholders took over a failing retirement home and turned it into a profitable operation. In the years at issue the Fletchers each received approximately $200,000 of compensation plus contributions to a defined benefit plan for each of approximately $191,000 for services respectively as the overall manager and head nurse. The court (Judge Goeke) agreed that the compensation to the taxpayers was catch-up compensation for years when the corporation provided little compensation, that the compensation levels were below national norms, that the corporation's cash-flow was marginally sufficient to pay its bills including acquisition indebtedness, but that the Fletchers as the shareholders used all of the profits to pay salaries and never received a dividend. The deciding factor for the court's holding that the compensation was unreasonable was that independent investors would have demanded at least a 10 percent return on their investment and that the compensation packages "did not leave enough of the corporation's assets to be paid back to the hypothetical investor as a return on investment." The court also held that compensation paid to the Fletchers' daughter was unreasonable. The court further declined the IRS's invitation to impose additions to tax under § 6651 and § 6662 accuracy related penalties, finding that the taxpayer reasonably relied on the advice of its accountant (with the exception of penalties related to the compensation paid to the Fletchers' daughter).

4. IRS experts prevail on reasonable compensation issues – surprise! And the court found taxpayer's position on equitable recoupment to be somewhere between "*Dalm* and Dahmer." K&K Veterinary Supply, Inc. v. Commissioner, T.C. Memo. 2013-84 (3/25/13). The taxpayer, a wholesaler of animal health products, was wholly owned by John Lipsmeyer, who was employed as its chief executive and worked as a principal sales representative. The taxpayer employed John's wife, Melissa, as vice president, secretary and assistant financial officer, John's brother David as senior vice president of sales, co-chief executive officer and co-chief operative officer who also handled 50 accounts, and David's daughter Jenifer as the chief financial officer. Accepting the IRS expert's evaluation, the Tax Court (Judge Cohen) reduced the corporation's deductions for compensation paid to the sole shareholder/employee and related parties. The court considered nine factors in evaluating reasonable compensation. Among those factors, the court determined that although John and David had significant experience with the corporation's operations and were important to its success, the record did not establish that either of them was the primary reason for the taxpayer's growth. The court indicated Jennifer's importance to the corporate success, but stated that the record fell short of establishing that she was exceptionally qualified or the primary reason for the corporation's growth. The court also stated that the record fell "far short" of establishing Martha's exceptional qualification or contribution to growth. Rejecting the taxpayer's expert analysis, the court accepted the prevailing salary comparison figures offered by the IRS expert and the IRS expert's conclusion of reasonable compensation from comparable companies at the 75th percentile.

- The court also rejected the taxpayer's assertion of an "equitable recoupment" to reduce the corporation's tax liability by the amount of lower taxes payable by shareholders if the excess compensation had been distributed to the shareholder as a dividend rather than reported by them as compensation income. The court listed four elements required for equitable recoupment to apply: "(1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one." *United States v. Dalm*, 494 U.S. 596 (1990). The court held that equitable recoupment was not available to the corporation because the denial of the corporate level deduction and the tax on dividends involved two or more taxpayers with insufficient identity of interest to be treated as a single taxpayer. The court observed that a corporation formed for legitimate business purposes and its shareholders are separate entities.

D. Miscellaneous Deductions

1. Standard mileage rate rules published in a revenue procedure while the amounts will be disclosed in a separate notice. Rev. Proc. 2010-51, 2010-51 I.R.B. 883 (12/3/10). The IRS indicated that beginning in 2011 it will publish mileage rates in a separate annual notice. The revenue procedure indicated that a taxpayer may use the business standard mileage rate to substantiate expenses for business use of an automobile in lieu of fixed and variable costs. Parking fees and tolls are deductible as separate items. The basis of an automobile used for business is reduced by a per-mile amount published in the annual notice. Separate rates are provided both for charitable use of an automobile and medical and moving use of an automobile. The revenue procedure also provides details for treating as substantiated a fixed and variable rate allowance for expenses incurred by an employee in driving an automobile owned or leased by the employee in performing services for the employer.

a. Standard mileage rates for 2012. Notice 2012-1, 2012-2 I.R.B. 260 (12/9/11). The standard mileage rate for rolling the tires after 1/1/12 remains at 55.5 cents (23 cents representing depreciation). The mileage rate for charitable service is 14 cents, and for medical care or moving expenses the rate is slightly down to 23 cents. The maximum standard automobile cost for computing the allowance under a fixed and variable rate (FAVR) plan is $28,000 for automobiles and $29,300 for trucks and vans.

b. Add one cent per mile for 2013 (except for charitable service). Notice 2012-72, 2012-50 I.R.B. 613 (11/21/12). The standard mileage rate for business miles in 2013 goes up to 56.5 cents per mile (with 23 cents representing depreciation), and the medical/moving rate goes up to 24 cents per mile. The charitable mileage rate remains fixed by § 170(i) at 14 cents.

c. The IRS announces per diem rates for travel away from home. Notice 2012-63, 2012-42 I.R.B. 496 (9/26/12). Per diem reimbursement rates in lieu of substantiated expenses under Rev. Proc. 2011-47, 2011-42 I.R.B. 520, effective for travel after 10/1/12, are unchanged from 2011. One revision, however, removes transportation expenses between points, lodging and meals, and mailing expense for travel vouchers from incidental expenses, so that these items may be separately reimbursed for travelers using the per diem method. Per diem rates are as follows:

- The special meals and incidental rates for the transportation industry are $59 within CONUS and $64 OCONUS.

- Incidental expense deduction for any location is $5 per day (the IRS believes in cheap tippers).

- Rates for travel within CONUS are $242 per day for high cost localities (listed in the notice) and $163 for all others. The portion allowed for meals is $65 in a high-cost locality and $52 for others.

d. Rev. Rul. 2012-27, 2012-41 I.R.B. 435 (10/4/12). The IRS has provided standard industry fare level cents-per-mile and terminal charges for the second half of 2012 for determining the value of non-commercial flights on employer provided aircraft. Under Reg. § 1.61-21(g) the value of a non-commercial flight is determined by multiplying the standard industry fare cents-per-mile rate by the applicable aircraft multiple and adding the applicable terminal charge.

2. Don Draper likely would have tried to take advantage of this rule had it been around when he was renting hotel rooms in NYC. REG–137589–07, Local Lodging Expenses, 77 F.R. 24657 (4/25/12). Prop. Reg. § 1.162-31 would allow a deduction for local lodging, i.e., lodging while the taxpayer is not away from home, in carrying on a taxpayer's trade or business (whether or not as an employee) under a "facts and circumstances" test. One factor is whether the taxpayer incurs the expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. (For employees the question usually is whether the employer-paid lodging is a working condition fringe benefit.) The proposed regulations provide a safe harbor for local lodging at business meetings and conferences. The examples indicate that there must be a bona fide business reason for the overnight stay, and, if provided by an employer, there must be a substantial noncompensatory reason. The regulations will be effective upon final publication, but pending finalization, taxpayers may rely on the proposed regulations.

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

3. Flying is entertainment, at least in the corporate aircraft. T.D. 9597, 77 F.R. 45480 (8/1/12), *corrected*, 77 F.R. 50373 (8/21/12). The Treasury Department has promulgated final regulations revising Reg. § 1.61-21(g)(14) and adding Reg. §§ 1.274-9 and 1.274-10, in addressing the disallowance of expenses under § 274(a) incurred in the use of taxpayer owned aircraft for entertainment. Under the regulations both fixed and variable expenses, including depreciation and interest expense, attributable to the use of taxpayer owned aircraft for entertainment are disallowed. Expenses are allocated on the basis of occupied seat miles or hours for entertainment travel relative to total seat miles or hours of aircraft use, or on a flight-by-flight basis. Expenses attributable to deadhead flights returning empty from an entertainment flight are included in the calculation. The Treasury Department rejected suggestions that expenses be determined on the basis of the primary purpose of a specific flight. Depreciation for the purpose of determining entertainment expenses may be calculated on a straight-line basis regardless of the depreciation method used by the taxpayer for other purposes. Aircraft with similar cost profiles that have the same type and number of engines can be aggregated in determining expenses allocable to use of the aircraft for entertainment. The regulations do not permit aggregation of the costs of all aircraft operated by the taxpayer. Expenses incurred for entertainment flights of specified employees (officers, directors, 10 percent owners) are excepted from disallowance under § 274(e)(2) only to the extent included in income as compensation by the recipient. Expenses in excess of the amounts included in income are disallowed. Also, expenses incurred to provide entertainment flights in taxpayer owned business aircraft to meet security concerns (which are excludable from the recipient's income as a fringe benefit) remain disallowed as deductions under § 274(a). The loss disallowance rules do not apply to expenses incurred by a commercial airline providing entertainment flights to "specified individuals" on a regularly scheduled flight on which 90 percent of the seats are offered for sale to the general public to the extent the entertainment flight is includable in the gross income of the specified individual.

4. The one who eats the food may not get the haircut: Proposed regulations allocate the § 274(n) limitations with respect to reimbursed meals. REG-101812-07, Reimbursed Entertainment Expenses, 77 F.R. 45520 (8/1/12). Section 274(n) limits otherwise allowable deductions for meals and entertainment to 50 percent of the expense. In the case of reimbursed meal or entertainment expenses that are not treated as income to the payor, § 274(e)(3) applies the limitation to the person claiming a deduction for the reimbursement. In *Transport Labor Contract/Leasing, Inc. v. Commissioner*, 461 F.3d 1030 (8th Cir. 2006), the court held that in a three-party reimbursement arrangement the § 274 limitation applied to the client who reimbursed an employee leasing company for meal expenses paid by the leasing company employer to contract truck drivers who were leased to a trucking company. The Eighth Circuit's opinion defined reimbursement arrangements by reference to definitions of an employer's accountable plan under § 62(a)(2)(A) and Reg. § 1.62-2. The proposed regulations would provide an independent definition of a reimbursement or expense allowance arrangement independent of the rules of § 62(a)(2)(A) and (c). Prop. Reg. § 1. 274-2(f)(2)(iv)(a)(D) would define a reimbursement arrangement as one under which an employee or independent contractor receives an advance, allowance, or reimbursement from an employer, client, or contractor for expenses incurred by the recipient. A reimbursement plan involving payments to an independent contractor would have to be memorialized in a written agreement that identifies the party subject to the § 274 limitations.

- In the case of an employer, the limitations of § 274 apply to the employer's deduction of reimbursed expenses, except to the extent that the employer treats the reimbursement or other payment as compensation paid to the employee and wages for withholding purposes.

- In case of reimbursements to an independent contractor, the limitations apply to the independent contractor to the extent that the independent contractor does not account to the client or customer for meals and entertainment expenses under the substantiation rules of

§ 274(d). Where the independent contractor accounts for meal and entertainment expenses, the limitations are applicable to the client or customer. The person responsible for the § 274 limitations can be specified in a written agreement between the parties.

- The preamble to the proposed regulations and proposed examples indicate that in a multiple party arrangement each relationship will be treated as a two-party relationship subject to the independent contractor rules, which thus would impose the § 274 limitations upon the party that reimburses expenses substantiated to it by another party. Again, persons in multiparty reimbursement arrangements would be permitted to specify by agreement which party is subject to the § 274 limitations.

5. **Cincinnati is one big metropolitan area.** Saunders v. Commissioner, T.C. Memo. 2012-200 (7/17/12). The taxpayer worked for a single employer, had no principal place of business, and travelled directly from home to temporary work sites located between 74 and 96 miles away. The taxpayer lived in Manchester, Ohio [more than 70 miles away from Cincinnati], and indicated that his "main area" was Cincinnati. The Tax Court (Judge Thornton) refused to allow the taxpayer's claimed deductions for travel away from home as expenses incurred for travel outside the metropolitan area where the taxpayer lives and normally works. The court noted that the term "metropolitan area" is ill defined, but concluded under the facts and circumstances that the taxpayer failed to establish that any of the temporary worksites to which the taxpayer travelled were outside of the Cincinnati metropolitan area; the two worksites identified in the opinion were 20 and 31 miles away from downtown Cincinnati, but were located within the Cincinnati-Middletown, OH-KY-IN Metropolitan Statistical Area as defined in OMB Bulletin No. 08-01 (Nov. 20, 2007).

6. **The Tax Court strikes a blow to the travel expense of two-earner couples.** Noz v. Commissioner, T.C. Memo 2012-272 (9/24/12). The court (Judge Morrison) disallowed travel expense deductions to married taxpayers who worked as university professors, one in New York, one in Stockholm. Although the married taxpayers collaborated with each other on articles and books, the court held, "On the basis of the frequency of travel, the personal relationship between the petitioners, and the petitioners' failure to offer any evidence, beyond broad generalities, of how the trips advanced any stated business purpose, we find that the New York-Stockholm trips were motivated primarily by personal concerns."

7. **Selling insurance is a service business not allowed a cost of goods sold, even to a former IRS agent.** Perry v. Commissioner, T.C. Memo. 2012-237 (8/16/12). Along with denying unsubstantiated travel and business expenses (including $3,000 to an airline employee to be designated her "travel companion" for discounted airfare), the Tax Court (Judge Kroupa) held that the taxpayer's business of selling insurance was not the sale of a material product to which direct cost may be allocated to reduce gross receipts as cost of goods sold.

8. **IRS tries to put a lid on wages recharacterized as reimbursements.** Rev. Rul. 2012-25, 2012-37 I.R.B. 337 (9/10/12). The IRS ruled that certain employer arrangements that substitute reimbursement for tools, travel, supplies and the like under a purported "accountable plan" for compensation for services do not meet the business connection requirement of § 62(c) and therefore fail as accountable plans. The IRS noted that such plans are intended to avoid the two-percent limitation on deduction of employee business expenses and payment of employment taxes on wages that are recharacterized as reimbursements. Citing Reg. § 1.62-2(d), the ruling indicates with three factual situations that the business connection requirement is not met where hourly compensation is reduced and replaced with a reimbursement arrangement that pays the same gross amount to the employee regardless of whether the employee incurs deductible business expenses. The ruling states that the fact that the employee actually incurs a deductible expense in connection with employment does not cure the wage recharacterization. Second, a plan that pays the same amount of reimbursement to employees

who have not actually incurred deductible expenses in connection with the employer's business fails the business connection requirement. In situation 4 of the ruling, the IRS indicates that a plan that reduces hourly compensation but only reimburses employees who incur expenses in connection with the employer's business and who are required to substantiate expenses, qualifies as a reimbursement plan notwithstanding substitution for the reimbursement plan for a portion of the hourly compensation.

9. **Texas professors denied bad debt deductions for related entity loans.** Herrera v. Commissioner, T.C. Memo. 2012-308 (11/5/12). The Tax Court (Judge Wherry) denied business bad debt deductions under § 166 for advances by one LLC to its sister, both of which were owned by two University of Texas El Paso engineering professors who used the LLCs for consulting and metal fabrication activities. Citing the 13 factors identified by the Fifth Circuit in *Texas Farm Bureau v. United States*, 725 F.2d 307 (5th Cir. 1984), the court found that advances were not bona fide debt, stressing the lack of a promissory note, the lack of a definitive maturity date, the lack of a repayment schedule, de facto subordination of the debt to other creditors, the absence of a requirement for security, and the fact that the source of payment was tied to the fortunes of the business. The court stressed the fact that no interest was paid as being particularly important.

10. **Friends from the Cheers bar don't provide business bad debt deductions until all hope is gone.** Alioto v. Commissioner, 699 F.3d 948 (6th Cir. 11/7/12). After the taxpayer hired John Ratzenberger (famous for his role in Cheers) he entered into a business venture with Ratzenberger to use celebrity talent in short form media to be sold as internet advertising. The taxpayer contended that he expected to be fully reimbursed for advances of his own money to the venture. Affirming the Tax Court (T.C. Memo. 2011-151), the Sixth Circuit (Judge Moore) denied business bad debt deductions because the taxpayer failed to meet his burden of proof that his losses were no longer subject to a reasonable prospect of recovery. The court rejected the taxpayer's testimony that he had received an e-mail from Ratzenberger's agent notifying the taxpayer that no further reimbursement would be forthcoming as insufficient proof, nor did the court accept the fact that the taxpayer filed bankruptcy as evidence that the debt was not recoverable. The court also denied the taxpayer's claim for a theft loss on the ground that there was no proof that Ratzenberger's actions amounted to larceny under Massachusetts law.

11. **The CEO and sole shareholder of a janitorial corporation used cocaine as a chick magnet, but can the corporation deduct the cleanup costs? Held, the price paid for the cocaine overdose death of the boss's girlfriend is not a deductible corporate business expense.** Cavanaugh v. Commissioner, T.C. Memo. 2012-324 (11/26/12). James Cavanaugh the CEO and sole shareholder of Jani-King International took a holiday trip to the Cavanaugh's villa in St. Maarten with his 27 year-old girlfriend, a body guard and another female Jani-King employee. Unfortunately the girlfriend died from an overdose of cocaine. The girlfriend's mother sued the individuals and the corporation for wrongful death. The taxpayer's S corporation paid the full amount of the settlement, including a $250,000 reimbursement to Cavanaugh and claimed a business expense deduction. The Tax Court (Judge Holmes) began its opinion in this case submitted under Tax Court Rule 122[1] as follows: "

[1] **RULE 122. SUBMISSION WITHOUT TRIAL**

(a) General: Any case not requiring a trial for the submission of evidence (as, for example, where sufficient facts have been admitted, stipulated, established by deposition, or included in the record in some other way) may be submitted at any time after joinder of issue (see Rule 38) by motion of the parties filed with the Court. The parties need not wait for the case to be calendared for trial and need not appear in Court.

Twenty-seven-year-old Colony Anne (Claire) Robinson left Texas in November 2002 for a Thanksgiving vacation in the Caribbean with her boyfriend, his bodyguard, and another employee of the company that he had spent decades building.

She did not return home alive.

The coroner's report showed a massive amount of illegal drugs in her body and concluded that they were the likely cause of her death. Her mother sued the boyfriend and his company for wrongful death. The parties settled. The company paid most of the $2.3 million settlement directly; the boyfriend contributed $250,000, which the company then reimbursed.

- Siding with the IRS, Judge Holmes looked to the origin of the claim, which the court held to be applicable to the corporation's payment in settlement of the wrongful death claim. The court concluded that although the claim related to the conduct of the three corporate employees, the conduct was not related to the corporate business, i.e., its profit-seeking activities. The court also rejected the taxpayer's theory that the bodyguard supplied cocaine in the course of his employment as a bodyguard and enabler for the CEO. Further, the court rejected the taxpayer's argument that reimbursement of the taxpayer's contribution to the settlement was contractually required under a corporate indemnity agreement. In addition, the court found that the payment was not deductible under the theory that it was made to protect the corporation's business reputation because there was no evidence that underlay that theory.

- Judge Holmes distinguished and refused to follow *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1980).

12. Puerto Rico may not be a state, but it's part of the U.S.A. for § 199 domestic production purposes. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 318, extends inclusion of manufacturing and production activities in Puerto Rico as domestic production activities for purposes of the § 199 domestic production activities deduction for the first eight years of a taxpayer beginning after 12/31/05 and before 1/1/14. Previously § 199 applied to the first six years of a taxpayer beginning after 12/31/05 and before 1/1/12.

13. Extended power to empowerment zones. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 327, extends designations of empowerment zones through 12/31/13. The designations, which were set to expire on 12/31/11, extends a 20 percent wage credit under § 1396, additional $35,000 of first year expensing under § 179, tax-exempt bond financing under § 1394, and capital gains deferral on replacement of qualified assets under § 1397B.

E. Depreciation & Amortization

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

a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations relating to depreciation of tangible property. Rev. Proc. 2012-20, 2012-14 I.R.B. 700 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy

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(b) Burden of Proof: The fact of submission of a case, under paragraph (a) of this Rule, does not alter the burden of proof, or the requirements otherwise applicable with respect to adducing proof, or the effect of failure of proof.

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

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

c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance announcing that pending final regulations will apply only in years beginning in 2014 and thereafter. Notice 2012-73, 2012-51 I.R.B. 713 (11/20/12). The IRS announced that pending final regulations will apply to taxable years beginning on or after 1/1/14, but that taxpayers will be permitted to apply the final regulations to taxable years beginning on or after 1/1/12. The notice also indicates that the temporary regulations may be revised with respect to the de minimis rule of § 1.263(a)-2T(g); dispositions under §§ 1.168(i)-1T and 1.168(i)-8T; and the Safe Harbor for Routine Maintenance under § 1.263(a)-3T(g).

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

e. **This announcement amends — really!!??** Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). An announcement amending regulations — the temporary regulations (T.D. 9564), regarding the deduction and capitalization of expenditures under §§ 162(a) and 263(a) relating to tangible property to apply to taxable years beginning on or after 1/1/14, while permitting taxpayers to apply the temporary regulations for taxable years beginning on or after 1/1/12, and before the applicability date of the final regulations.

2. **Shockwave's shocking mechanical defects fail to hook GO Zone bonus depreciation.** Blakeney v. Commissioner, T.C. Memo. 2012-289 (10/15/12). In February 2006 the taxpayer took possession of a new $3.9 million charter fishing yacht, Shockwave, to be based in Orange Beach, Alabama, a city within the Gulf Opportunity Zone. Unfortunately multiple mechanical difficulties forced the boat to be tied up for repairs in the Caribbean until October 2006 when it was delivered to Orange Beach. Unfortunately, the fishing season ended in September so that the taxpayer was not able to charter the boat in Orange Beach during the remainder of 2006. The taxpayer did, however, manage to charter the boat in the Caribbean for 43 days between repairs. The 50 percent bonus depreciation deduction of § 1400N is available for property placed in service after 8/28/05, substantially all of the use of which in the active conduct of a trade or business is in the Gulf Opportunity Zone. The court (Judge Vasquez) held that the 74 days during which the boat was available for charter in Orange Beach constituted use within the GO zone, even though the boat was not hired for charter during that period. The court also held that the boat was not available for use during the time it was laid up for repairs. However, the court treated the 43 days of charter service in the Caribbean as use outside of the GO zone and held that the 63 percent use (74/117) within the GO zone was not substantially all under § 1400N(d)(2)(A)(ii). The court indicated that it was not necessary to address whether the 80 percent use requirement of Notice 2006-77, 2006-2 C.B. 590, was entitled to deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

3. **First year bonus depreciation extended for one year by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act.** The first year bonus depreciation of 50 percent of adjusted basis of property with a MACRS recovery period of 20 years or less is extended to property placed in service before 1/1/14 and to certain transportation property placed in service before 1/1/15. The 50 percent allowance is available for depreciable machinery and equipment and most other tangible personal property, and is available for computer software and certain leasehold improvements, the first use of which began with the taxpayer. The 2012 Act also extends the provisions in § 168(e)(3)(E) treating qualified leasehold improvement property and qualified restaurant property as 15 year property, also eligible for the first year bonus depreciation.

4. **Section 179 limits are extended again – is this becoming permanent like research credits?** The 2012 Taxpayer Relief Act, § 315(a) retroactively extended, the Code § 179 first year expensing for tax years beginning in 2012 and 2013 in an amount not to exceed $500,000 with a phase-out amount beginning at $2,000,000. For tax years beginning after 2013 the maximum deduction drops to $25,000 with the phase-out beginning at $200,000 (at least until the business community again makes sufficient campaign contributions to extend the higher numbers into later years).

a. **The sunny side of inflation.** Rev. Proc. 2011-52, 2011-45 I.R.B. 701, § 3.20 (11/7/11). As adjusted for inflation and before extension by the 2012 Act, as provided in § 179(b)(6), the 2012 ceiling for expensing machinery and equipment and certain other § 1231 property was $139,000, and the phase-out threshold was $560,000. The retroactive application of the 2012 extension to tax years beginning in 2012 provided a windfall to taxpayers who exceeded the 2012 thresholds.

b. **Section 179 is applied to computer software for another year.** The 2012 Taxpayer Relief Act, extends for another year eligibility as qualified Code § 179 property to off-the-shelf computer software placed in service before 2014.

5. **Mine safety equipment eligible for 50 percent expensing.** The 2012 Act, § 316, extends the election under § 179E to expense 50 percent of mine safety equipment to apply to property placed in service on or before 12/31/13.

6. **2012 depreciation tables for business autos, light trucks, and vans are to be increased by the 2012 Tax Relief Act with an additional $8,000 of first year recovery.** Rev. Proc. 2012-23, 2012-14 I.R.B. 712 (3/2/12). The IRS published depreciation tables with the depreciation limits for business use of small vehicles:

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

1st Tax Year	*$11,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*

Each Succeeding Year	*$1,875*

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

1st Tax Year	*$11,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

Section 168(k), as extended by the 2012 Act to property placed in service by 12/31/13, provides an additional $8,000 first year recovery

Passenger Automobiles not eligible for § 168(k) first year recovery,

1st Tax Year	*$3,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*

Trucks and Vans not eligible for § 168(k) first year recovery,

1st Tax Year	*$3,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

- The revenue procedure also has tables for leased vehicles.

7. The IRS identifies property eligible for 100 percent depreciation, including the unintended consequences for business autos. Rev. Proc. 2011-26, 2011-16 I.R.B. 664 (3/29/11). 2010 tax acts extended the placed-in-service date for property to be eligible for the § 168(k)(1) 50 percent first year depreciation allowance to property placed in service before 2013 (2014 in the case of certain property described in § 168(k)(2)(B) and (C)) and adopted § 168(k)(5) to allow a 100 percent depreciation deduction for qualified property acquired after 9/8/10 and before 1/1/12, and placed in service before 1/1/12. The revenue procedure sets out several rules for the application of these provisions.

- Reg. § 1.168(k)-1(b)(4)(iii)(C)(1) and (2) provide that if the larger part of self-constructed property commences before the applicable dates for the 50 percent depreciation deduction, components self-constructed after the effective date are also ineligible for the accelerated deduction. If the construction of the larger part of self-constructed property begins before 9/9/10, but the qualified property otherwise qualifies for the 50 percent depreciation deduction, self-constructed components after 9/9/10, that are qualified property may be subject to an election to claim 100 percent depreciation deductions with respect to the component.

- Section 168(k)(2)(D)(iii) provides an election not to claim first year depreciation with respect to a "class of property" placed in service during the taxable year. Reg. § 1.168(k)-1(e)(2)(i) applies the election to each class of property described in § 168(e). The revenue procedure allows an election to claim 50 percent first year depreciation rather than 100 percent depreciation for a class of property.

a. The passenger automobile anomaly. The additional first year depreciation allowance is limited to $8,000 for passenger automobiles and light trucks subject to the § 280F limitations ($3,060, $4,900, $2,950 in years one through three respectively, and $1,775 in years four through six). Thus the first year depreciation allowance in year one is $11,060 ($3,060 plus $8,000). This allowance is treated as the 100 percent depreciation deduction. Under § 280F(a)(1)(B)(i), unrecovered passenger automobile basis is treated as a deductible expense (up to $1,775) in each year after the sixth year. Unless the taxpayer elects to forego 100 percent depreciation recovery with respect to a passenger automobile, the taxpayer would be treated as claiming 100 percent depreciation in year one, with no further deductions allowable in years two through six. The revenue procedure provides a safe harbor method of accounting that the taxpayer is deemed to apply by deducting depreciation of the passenger automobile for the first taxable year succeeding the placed-in-service year. In effect, the revenue procedure continues to treat passenger automobile and light truck depreciation as if the first year deduction were 50 percent depreciation.

b. The 2012 Act extends the eligibility to property placed in service before 1/1/14.

8. Not all self-created intangibles are nonamortizable. Fitch v. Commissioner, T.C. Memo. 2012-358 (12/26/12). The taxpayer sold his CPA practice to another accountant for $900,000 after suffering severe medical problems that led to brain surgery. Approximately 4-1/2 months after the sale, the purchaser suffered a seizure and was hospitalized. Five days later and in the same year as the original sale, the purchaser sold the practice back to the taxpayer for $900,000. The taxpayer claimed § 197 amortization deductions with respect to the cost of intangibles reflected in the $900,000 repurchase price, and the IRS denied the deductions. The IRS position was based on alternative arguments that (1) "the alleged sales agreements petitioners submitted are untrustworthy and the alleged sales did not take place," (2) that the original transaction was rescinded, and (3) that the taxpayer reacquired self-created intangibles in a series of related transactions. The Tax Court (Judge

Vasquez) found that in light of the circumstances leading to each transaction, the two sales and purchase transactions were unrelated and genuine. Furthermore, the second transaction was not a mere rescission. Thus, the exception to the prohibition on amortization of certain self-created intangibles in Reg. § 1.197- 2(d)(2)(iii)(C), which allows amortization if a taxpayer disposes of a self-created intangible and subsequently reacquires the intangible from a seller (in whose hands the intangible is amortizable) in an unrelated transaction, applied.

- The court dealt with the government argument that the second transaction was a rescission of the first by noting that a rescission required putting the parties back in the same place they were before the first transaction occurred, and this was not possible for an active business four and one-half months after the first transaction occurred. *See generally*, Sheldon I. Banoff, "Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?" 62 Taxes 942 (December 1984).

- This case takes to an extreme the first part of the quotation from Heraclitus, who said "No man ever steps in the same river twice, for it's not the same river and he's not the same man." Compare *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 (3/14/96), where the Tax Court (Judge Raum) rejected an argument that there was a rescission of a large block of WalMart stock sold in the stock market because rescission would have required that each of the buyers in the sale be located and be persuaded to reverse each sale, and that was not done.

9. Tax incentives for "first peoples" -- accelerated depreciation for property on Indian Reservations is extended. The 2012 Tax Relief Act, extends the shortened recovery periods of § 168(j) to property placed in service on Indian reservations before 12/31/13.

F. Credits

1. You can't consume your supplies in research and sell them too. Union Carbide Corp. v. Commissioner, 697 F.3d 104 (2d Cir. 9/7/12), *aff'g* T.C. Memo. 2009-50, *cert. denied* (3/18/13). The Second Circuit (Judge Pooler) held that raw materials used in three discontinued research products that were ultimately converted to products sold by the taxpayer were not eligible for inclusion as part of qualified research expenditures for the 20 percent research credit of § 41(a). The court specifically held that the costs of supplies used during research projects that would have been used in the course of the taxpayer's manufacturing process regardless of the research do not qualify under §§ 41(b)(2)(A)(ii) and 41(h)(1)(B) as "an amount paid or incurred for supplies used in the conduct of qualified research." The court, not willing to make "a fortress out of the dictionary," determined that the phrase "used in the conduct of qualified research" encompassed only supplies purchased for the purpose of conducting research, although supplies consumed in the normal manufacturing process were necessary to the research focused on more efficient methods of converting the raw materials to finished product. The court also noted that any ambiguity in the statute could be resolved by giving deference to the agency interpretation of the statute "even if that interpretation appears in a legal brief." The court found that the IRS's interpretation of the statute was consistent with the purpose of the research credit. In a concurring opinion Judge Pooler observed that if Congress had intended the supplies at issue to be creditable, it would have so provided in precise terms on a subject of industry lobbying.

2. Gross receipts are not defined by the narrow definition of Black's Law Dictionary, the regulations provide better guidance. Hewlett-Packard Company v. Commissioner, 139 T.C. No. 8 (9/24/12). For the tax years at issue the taxpayer elected the alternative incremental research credit (AIRC) method of computing the § 41 research credit, which provided a credit equal to the sum of: (i) 2.65% (1.65% for 1999) of so much of the qualified research expenditures (QRE) from the tax year as exceeded 1% of annual adjusted gross receipts (AAGR), but did not exceed 1.5% of those AAGR; (ii) 3.2% (2.2% for 1999) of so much of the QRE from the tax year as exceeded 1.5% of AAGR, but did not exceed

2% of those AAGR; and (iii) 3.75% (2.75% for 1999) of so much of the QRE from the tax year as exceeded 2% of AAGR. In 1999 Treasury proposed regulations to provide that adjusted gross receipts for this purpose include in addition to sales receipts (as adjusted for returns and allowances) other sources of gross income such as interest, dividends and rents. The final regulations adopted the provision but with an effective date for tax years beginning after the date of the final regulations, 1/3/01. For its tax years 1999 through 2001 the taxpayer calculated its credit on the basis of adjusted gross receipts that did not include income other than sales income. The Tax Court (Judge Goeke) concluded that the final regulations were a proper interpretation of the statutory language and legislative intent and that the Treasury's logic in embracing a definition of gross receipts as articulated in the preamble to the proposed regulations applies to taxable years preceding the effective date of the regulations. Thus the court adopted a definition of gross receipts that includes the total amount derived by a taxpayer from all activities and sources. The court rejected the taxpayer's argument that by adopting § 41(c)(4) (excluding "returns and allowances" from gross receipts), Congress indicated an intent to limit the concept of gross receipts for § 41 purposes to sales receipts. The court also refused to adopt a narrow "common law meaning" of gross receipts from Black's Law Dictionary as undermined by numerous statutory authorities using the term. Further, the court indicated that the maximum "*expressio unius est exclusio alterius*" applies to indicate that congressional enumeration of specific exceptions to gross receipts means that other exceptions are not to be implied.

3. Business tax credits extended and liberalized by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act. The business tax credits extended include:

a. Research credit of § 41 for 20 percent of research expenditures over a base amount, 20 percent of basic research payments to universities and 20 percent of qualified energy research by an energy consortium is retroactively extended for two years to cover research expenditures incurred before 1/1/14. The new law also provides that the acquirer of a trade or business, or of a substantial portion of a business unit, may include certain qualified research expenditures of the predecessor and must include the gross receipts of the predecessor in calculating credits available to the acquirer. For controlled corporations, under § 41(f) all of the members are treated as a single taxpayer and the research credit and the credit allowable to each member is to be determined in proportion to its share of research expenditures.

b. Railroad track maintenance. The 2012 Act, § 306, extends the 50 percent credit of § 45G for qualified railroad track maintenance expenditures of up to $3500 per mile incurred by a qualified railroad owner to tax years beginning before 1/1/14.

c. Mine Rescue Training. The 2012 Act, § 307, extends the 20 percent credit of § 45N for costs of training qualified mine rescue employees to taxable years beginning before 12/31/13.

G. Natural Resources Deductions & Credits

1. Business energy related tax credits extended by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act. The tax credits extended include:

a. Alternative vehicle fuel property. Section 402 of the Act extends the Code § 30C alternative fuel vehicle refueling property 30 percent credit, limited to $30,000 for depreciable property and $1,000 for other property, to property placed in service before 1/1/14.

b. Electric vehicles. Section 403 of the Act extends the Code § 30D credit for two or three wheel electric vehicles of $2,500 to $5,000 depending on battery power to vehicles acquired before 1/1/14.

c. Plant gas. Section 404 of the Act extends the per gallon credit for alcohol used as fuel to production before 1/1/14, and provides rules for using algae as qualified feedstock for fuel produced after 1/2/13 [the date of enactment]. In addition, § 410(b) of the Act extends the additional 50 percent depreciation allowance of Code § 168(l)(2) for biofuel plant property placed in service before 1/1/14.

d. Biodiesel, i.e., the timing of the Iowa primary; even Al Gore has given up on ethanol. Section 405 of the Act extends the Code § 40A $1.00 per gallon credit for biodiesel mixtures to fuel sold or used before 1/1/14.

e. Indian coal. Section 406 of the Act extends the $2 per ton additional renewable energy credit under § 45(e)(10) for coal produced at an Indian coal production facility and sold by the taxpayer during an eight year period beginning on 1/1/06.

f. Energy efficient homes. Section 407 of the Act extends the Code § 45L credit to contractors of $2,000 (or $1,000 in the case of certain manufactured homes) that are certified as energy efficient to homes acquired from the contractor for use as a residence on or before 12/31/13.

g. Refrigerators, dishwashers and washing machines. Section 409 of the Act retroactively extends for two years the credit under Code § 45M to energy efficient appliances manufactured in 2012 and 2013.

h. Transmission line sales. Section 411 of the Act extends the Code § 451(i) eight year amortization of gain recognized on sales of transmission lines by a qualified vertically integrated electric utility to an independent transmission company to sales before 1/1/14.

i. Alternative fuel excise tax credit. Section 412 of the Act retroactively extends through 2013 the excise tax credits of Code § 6426 for alternative fuels and fuels mixtures.

2. Hurry to get in line for Qualified Advanced Energy Project credits. Notice 2013-12, 2013-10 I.R.B. 543 (2/7/13). The IRS has announced that phase II of § 48C credits for establishing a manufacturing facility to produce advanced energy property will provide an allocation of $150,228,397 of credits. Section 48C(a) provides a 30 percent credit for investment in the taxable year in a qualifying advanced energy project certified by the IRS on recommendation by the Department of Energy. The maximum credit for any project is $30 million. A concept paper must be submitted to DOE (electronically) by 4/9/13. If invited by DOE, the § 48C application must be submitted by 7/23/13. The DOE will rank applications. The highest ranked application will receive the full $30 million credit, down the list until the amount of available credits is exhausted.

H. Loss Transactions, Bad Debts, and NOLs

1. Unless you think you have a CERT – no it's neither a breath nor a candy mint – or a CERIL, don't punish yourself by reading these proposed regulations just for fun. REG–140668–07, Regulations Regarding the Application of Section 172(h) Including Consolidated Groups, 77 F.R. 57452 (9/17/12). The corporate equity reduction transaction (CERT) rules of § 172(b)(1)(E) and (h) were enacted in 1989 to limit a corporation's ability to obtain tax refunds as the result of the carryback of NOLs that were attributable to interest deductions allocable to leveraged buyout transactions. Sections 72(b)(1)(E) and (h) limit the carryback of the portion of an NOL that constitutes a "corporate equity reduction interest loss" (CERIL) of an "applicable corporation" in any "loss limitation year." Prop. Reg. §§ 172(h)-0 through -5 provide general rules addressing whether a CERT has occurred, the computation of a CERIL, and the treatment of successor corporations.

2. ATNOLD is not a breath mint to relieve your AMT problems. Metro One Telecommunications Inc. v. Commissioner, 135 T.C. 573 (12/15/10). In computing AMTI, § 56(a)(4) allows a corporation to claim an AMT NOL in lieu of a regular NOL deduction allowed under § 72. The taxpayer claimed an AMT NOL deduction for 2002 based on a carryback of an AMT NOL from 2004. Analyzing a very complicated statutory pattern, Judge Paris held that § 56(a)(1) does not allow for an AMT NOL carryover to a prior year.

a. On appeal, the Ninth Circuit affirms and holds that a "carryover" is a "carryforward," but not a "carryback." Metro One Telecommunications Inc. v. Commissioner, 704 F.3d 1057 (9th Cir. 12/19/12). For tax years 2002 through 2009 the Relief Rule of § 56(d)(1) allowed taxpayers to offset 100 percent of AMTI by an alternative tax net operating loss deduction (ATNOLD) which consisted of NOLs that were (1) "carryovers" to the 2001 and 2002 tax years or (2) carried back from 2001 or 2002 tax years to a prior year. The Ninth Circuit (Judge N.R. Smith) ruled that Metro One was precluded from carrying back net operating losses from 2004 to offset 100 percent of 2002 AMTI, but was limited to offsetting 90 percent of the 2002 AMT under former § 56(d)(1)A)(i)(II). The court indicated that the "plain meaning" of the term "carryovers" in the Relief Rule prevents taxpayers from using NOLs that are carried back from a later tax year. The use of the term "carryover" in § 172 is synonymous with "carryforward."

I. At-Risk and Passive Activity Losses

1. The taxpayer loses, but not as badly as he would have had the IRS properly argued the case. Veriha v. Commissioner, 139 T.C. No. 3 (8/8/12). The taxpayer was the sole owner of JVT, a C corporation that conduced a trucking business in which he actively participated. JVT leased the tractors and trailers used in its business from TRI, an S corporation in which the taxpayer owned 99 percent of the stock, and JRV, a single-member LLC wholly owned by the taxpayer and thus a disregarded entity. Each lease of a tractor or trailer was governed by a separate contract. During the year in issue, TRI realized net income and JRV realized a net loss. The taxpayer treated the net income from TRI as passive income and treated the net loss from JRV as a passive loss. The IRS determined that pursuant to Reg. § 1.469-2(f)(6) — the self-rental recharacterization rule — each tractor and each trailer should be considered a separate "item of property" and that the income the taxpayer received from TRI should be recharacterized as nonpassive income, while the net loss realized by JRV remained a passive activity loss. Reg. § 1.469-2(f)(6) provides as follows: "An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property— (i) Is rented for use in a trade or business activity . . . in which the taxpayer materially participates . . . ." The Tax Court (Judge Wells) rejected the taxpayer's argument that all of the tractors and trailers collectively were one "item of property," and looking to *Webster's Third New International Dictionary* 1203 (2002) for the definition of the term "item" held that for purposes of applying Reg. § 1.469-2(f)(6), each individual tractor or trailer was an "item of property," and the income received from TRI was subject to recharacterization. However, because the IRS had not contested the taxpayer's netting of gains and losses within TRI, only TRI's net income was recharacterized as nonpassive income that could not be offset by losses from JRV.

- Judge Wells noted that the result was more favorable to the taxpayer than the result would have been if the IRS had taken the position — which was consistent with Judge Well's analysis of the meaning of the regulations — that the income from each tractor or trailer within TRI and JRV should have been recharacterized as nonpassive.

2. Cell tower rentals escape the self-rental rule. Dirico v. Commissioner, 139 T.C. No. 16 (11/13/12). The taxpayer's wholly owned S corporation was engaged in the business of operating specialized mobile radio services (SMR, a precursor to cellular services) which included numerous antenna towers. The taxpayer individually leased towers to the S corporation, which in turn leased space on the towers to cellular companies. The S corporation reported all of its income from its combined activities as ordinary business income. The IRS recharacterized the taxpayer's rental income from profitable tower leases as non-passive activity income under the self-rental rule of Reg. § 1.469-2(f)(6), which applies to rental income from property rented for use in a trade or business in which the taxpayer is a material participant. (The IRS characterized losses from unprofitable leases as passive.) The Tax Court (Judge Halpern) rejected the IRS argument that the S corporation rented cell tower space to third parties as part of its SMR business. The court concluded that the minimal services provided by the S corporation to third-party lessees such as painting the towers, making sure the lights worked, and removing snow, meant that the leasing of towers and land to unrelated parties was a rental activity within the meaning of § 469(j)(8) and Temp. Reg. § 1.469-1T(e)(3)(i). The rental activity complemented, but was not part of the SMR business. The court also rejected the IRS argument that the S corporation's grouping of the rental income with ordinary business income was proper and binding on the taxpayer even though the taxpayer had the same proportionate ownership in the S corporation business and the rental property under Reg. § 1.469-4(d)(1)(i)(C). The court indicated that no portion of the S corporation's use of the towers in its SMR business was rental and thus its rental of towers to third parties produced only rental income. Thus, the corporation's use of the towers for rental did not produce trade or business income supporting application of the self-rental to the taxpayer that could properly be combined into a single economic activity. Because the taxpayer derived his rental income from the S corporation as a lessor to the corporation, and not as its shareholder, the court held that the erroneous grouping of activities by the corporation was not binding on the taxpayer under the last sentence of Reg. § 1.469-4(d)(5)(i) ("A shareholder *** may not treat activities grouped together by a section 469 entity as separate activities"). The court concluded that while Reg. § 1.469-4(e)(1) "prohibits only the regrouping of activities by "the taxpayer" (in this case, [the corporation]) and, therefore, constitutes a limitation on the manner in which the taxpayer (i.e., [the corporation]) reports its income for purposes of section 469. It does not affect petitioner's reporting of [the corporation's] rental payments to him."

- The IRS also classified land rental income as non-passive under Temp. Reg. § 1.469-2T(f)(3), which provides that if less than 30 percent of the unadjusted basis of rental property is subject to depreciation under § 167 net passive activity income from the property will be treated as non-passive income. The regulation converts rental income from raw land to non-passive income. The court agreed with the IRS that under Reg. § 1.469-4(d)(2) an activity involving the rental of real property and an activity involving the rental personal property cannot be combined into a single activity. Thus, the unadjusted basis of the towers and land could not be combined with the basis of raw land for purposes of the 30-percent rule.

- The court further rejected the taxpayer's argument that the IRS assertion of the 30-percent rule should be rejected because it was first raised on brief. While the court agreed that the IRS's raising the argument was not timely causing an element of surprise, the court found that the taxpayer was not prejudiced by the argument since all of the evidence necessary to resolve the issue was presented at trial.

3. Ill bank president is not a real estate professional. Harnett v. Commissioner, T.C. Memo. 2011-191 (8/11/11). The taxpayer founded a savings and loan association to provide financing to customers of his real estate development company. In 2003 the taxpayer suffered a heart attack and other health problems. He resigned as CEO of the bank in 2005, but continued to work as a consultant to the bank and served as chairman of the board. After 2003 the taxpayer had stopped renting his real estate properties and had begun trying to sell them. The real estate was managed partly by the taxpayer's son, his wife, and his former bank secretary. The court (Judge Thornton) found that the taxpayer's unsubstantiated testimony did not meet the burden of proof required to establish that the taxpayer had performed more than 750 hours of service during the tax years at issue and thus failed to qualify as a real estate professional for purposes of § 469(c)(7). The taxpayer's real estate losses were, therefore, passive activity losses not deductible against active income sources. The court found that the taxpayer's statement that he spent most of his time on real estate activities and only 10 hours a month at the bank strained credibility since "for most of this period he was both chairman of the board and CEO of the bank, with wide-ranging responsibilities and six-figure compensation" and added that the court saw no reason to think that managing the taxpayer's dormant real estate holdings required him to spend anywhere near 750 hours each year.

a. Affirmed per curiam. Harrnett v. Commissioner, 110 A.F.T.R.2d 2012-6628 (11th Cir. 11/14/12) (unpublished opinion).

4. Section 183 is a more powerful sword for the IRS than § 469. Disallowance is more powerful than basketing. Pederson v. Commissioner, T.C. Memo. 2013-54 (2/20/13). The Tax Court (Judge Goeke) upheld the IRS's application of § 183 to disallow losses claimed with respect to an investment in a marketed horse breeding "program" in which the taxpayer had no direct involvement. The taxpayer did not have a good-faith belief that the horse breeding activity would turn an overall profit; the amount invested was based principally on the amount necessary to produce the desired tax losses; and participation in the breeding program was almost entirely motivated by tax benefits purportedly available to the taxpayer through such participation.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Section 1221(a)(1) says "to customer*s* in the ordinary course of business" (emphasis added), not "to a customer." Bennett v. Commissioner, T.C. Memo. 2012-193 (7/12/12). The taxpayer was a "serial entrepreneur" who constructed a single residence for purposes of resale at profit, but which he sold at a substantial loss after five years. The Tax Court (Judge Wherry) upheld the IRS's determination that the residence was a capital asset, not property held for sale to customers in the ordinary course of business described in § 1221(a)(1), thereby denying ordinary loss treatment and subjecting the loss to § 1211 limitations. The taxpayer was not a real estate broker, had never before (or after) dealt in real estate, and did not have a contract to sell the property in place when he commenced construction. He did not meet the burden of showing that the real estate activity was a trade or business rather than an investment.

2. The taxpayer lost his claim that a qui tam relator's reward for ratting out HCA for Medicare fraud was a capital asset, while in the meanwhile the alleged mastermind of the HCA Medicare fraud scheme won the Florida gubernatorial race. Alderson v. United States, 686 F.3d 791 (9th Cir. 7/18/12). The taxpayer was a qui tam relator who filed a refund claim based on the argument that his share of the government's recovery (16 percent of $631 million) from the Hospital Corporation of America, Inc. (and several medical providers related to HCA) for Medicare fraud was capital gain rather than ordinary income. When Alderson, who was the CFO of an HCA related corporation (Quorum), was asked to prepare two sets of books, one for the hospital's financial auditors and one to serve as the basis for the hospital's Medicare cost reports, he refused to prepare separate books and was fired. Using information obtained during discovery in his wrongful termination suit, Alderson filed a qui tam suit against Quorum, HCA, and affiliated companies under the False Claims Act (31 U.S.C. §§ 3729 et seq.). Alderson made available to the United States the documents he had received during discovery, and eventually the government intervened in the suit. The Ninth Circuit (Judge Fletcher) affirmed the District Court's holding for the government. First, the court rejected the taxpayer's claim that he "'exchanged his documents, information and know-how[ ] and . . . received cash, thus consummating a sale or exchange . . . ,'" reasoning that the taxpayer "did not 'sell' or 'exchange' his information." His right to a relator's share for pursuing his qui tam suit that was conferred by the FCA was subject to a statutory precondition that he share his information with the government. Second, the information regarding HCA and its affiliates was not the taxpayer's "property." The taxpayer had no legal right to exclude others from use of the information, the information was known to other officials in the companies, and the taxpayer had no right to prevent those officials from providing the information to others. The court also rejected the taxpayer's argument that his relator's share, which he argued appreciated in value from the time he filed his suit until he received payment, was the relevant capital asset. The taxpayer had no "underlying investment of capital," and the increase in value "did not 'reflect an accretion in value over cost to [the] underlying asset.'" The taxpayer "was not an investor who bought and held an asset that increased in value during the holding period, but "worked intensively . . . to increase the likelihood that his qui tam suit would be successful." Finally, the court summarily dismissed the taxpayer's argument that the increase in value of the claim was a capital asset under § 1234A, on the grounds that § 1234A only applies with respect to assets that are capital assets to start with.

3. Be still open transaction doctrine! Let's fight over the proper basis apportionment method. Dorrance v. United States, 877 F. Supp. 2d 827 (D. Ariz. 7/9/12). The taxpayers, who originally had purchased life insurance from a mutual life insurance company, received stock when the life insurance company demutualized; they retained the life insurance policies. The Form 1099-B that the taxpayers received, consistent with IRS policy, listed the basis in the stock as zero. When the taxpayers sold the stock, they reported it as having a zero basis and filed a refund claim seeking summary judgment based on the argument that the open transaction doctrine applied to the demutualization and that the basis in the life insurance policies resulting from the payment of premiums should be allocated to the stock with the result that all of the proceeds from the stock sale were a return of capital and they thus owed no tax. The government sought summary judgment on the theory that no part of the insurance premiums was paid to acquire the mutual rights under the policy, and that the entire premium was paid to purchase the policy, with the result that the stock received in exchange for the mutual rights had a zero basis. The District Court denied both motions, holding, first, that the open transaction doctrine did not apply, rejecting the Court of Federal Claims decision in *Fisher v. United States*, 82 Fed. Cl. 780 (Fed. Cl. 2008), which accepted the taxpayer's argument that the open transaction doctrine applied, allowing the taxpayer to treat all of the premium payments he had made during the course of the policy as capital investment where the taxpayer received a cash payment in exchange for his mutual rights during the demutualization of a life insurance company. The court noted that if the taxpayer was "allowed to use the open transaction doctrine in the context of stock received during demutualization, he 'is getting a windfall, because all of the basis may be allocated to the assets that will be sold, while the asset that does not require basis has had its basis reduced.'" The court also rejected the government's position, finding that the value of both the mutual rights and the policy itself at the time of demutualization could be determined. However, neither party had presented evidence from which the court could equitably apportion the premiums paid before demutualization as basis in the mutual rights and basis in the policies themselves. The court instructed the parties to bring forward arguments for choosing between two different valuation methods: (1) compare the cost of the policies to the cost of comparable policies issued by non-mutual insurance companies at the time of issuance; or (2) comparing the market value of the policy and the stock at the time of demutualization, and applying that ratio to the premium payments.

4. Should the name of the promoter of this tax scam have been "Devious," instead of "Derivium?" Calloway v. Commissioner, 135 T.C. 26 (7/8/10) (reviewed). In 2001 the taxpayer entered into an agreement with Derivium Capital LLC pursuant to which he transferred 990 shares of IBM common stock to Derivium under its 90-percent-stock-loan program. The terms of the agreement characterized the transaction as a loan, with the IBM stock pledged as collateral. (Derivium was not registered with the New York Stock Exchange or the National Association of Securities Dealers/Financial Industry Regulatory Authority.) The purported loan was nonrecourse; interest accrued but was not payable until maturity; all dividends were applied against interest due; prepayment during the 3-year term of the purported loan was prohibited. The terms of the agreement allowed Derivium to sell the stock and retain the proceeds, which it did immediately upon receipt, receiving $103,918.18. The taxpayer received $93,586.23 from Derivium, the amount of the payment being determined, and payment being made, only after Derivium had sold the stock. Upon maturity of the "loan," the taxpayer had the option of (1) paying the balance due and having an equivalent amount of IBM stock returned to him, (2) renewing the purported loan for an additional term, or (3) satisfying the "loan" by surrendering any right to receive IBM stock. At maturity in August 2004 the balance due was $124,429.09, which was $40,924.57 more than the then $83,318.40 value of the IBM stock. (Derivium had credited against the accrued interest the amount of dividends that would have been received had the stock not been sold, but the taxpayer never received a Form-1099-DIV or included any dividends in income.) The taxpayer elected to satisfy his purported loan by surrendering any right to receive IBM stock. The taxpayer never made any payments toward either principal or interest on the purported loan. Citing *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *Gregory v. Helvering*, 293 U.S. 465 (1935), for the proposition that substance controls over form, the Tax Court, in a reviewed opinion by Judge Ruwe (with no dissents but with Judges Halpern, Wherry, and Holmes concurring in result only), held that the 2001 transaction between taxpayer and Derivium was a sale, not a loan, under the test factors set forth in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981). The taxpayer had transferred all the benefits and burdens of ownership of the stock to Derivium. Legal and equitable title, as well as possession and control of the stock were transferred in exchange for $93,586.23 with no obligation to repay that amount. "At best [the taxpayer] had an option to purchase an equivalent number of IBM shares after 3 years at a price equivalent to $93,586.23 plus 'interest.'" The transaction was not a true loan because "[f]or a transaction to be a bona fide loan the parties must have actually intended to establish a debtor-creditor relationship at the time the funds were advanced." There was no such intent. After the 2001 transaction the taxpayer never treated the transaction as a loan; in 2004 he did not report either a sale of the stock or cancellation of debt income, positions which were inconsistent with treating the transaction as a loan. Because Derivium was not acting as a broker, the court also rejected the taxpayer's argument that the transaction was analogous to the securities lending arrangement in Rev. Rul. 57-451, 1957-2 C.B. 295, which held that no sale occurred when the owner of stock deposited shares with a broker who could lend the securities until such time as the shareholder received from the broker property other than identical securities. Nor was the transaction equivalent to a securities lending arrangement under § 1058, because the agreement did not meet the requirements of that provision, which under *Samueli v. Commissioner*, 132 T.C. 37 (2009), requires that the transferor of the stock retain "all of the benefits and burdens of ownership of the transferred securities" and the right to "be able to terminate the loan agreement upon demand." Because the taxpayer could not regain possession of the stock for three years, his opportunity for gain was diminished.

- Section 6662 accuracy-related penalties were sustained.

- Judge Halpern's concurring opinion emphasized that the *Grodt & McKay* test, while appropriate for determining whether there had been a sale of property that was not fungible, was not useful in the determination of whether there had been a sale of fungible property, such as corporate stock. It was enough for him that the taxpayer "gave Derivium the right and authority to sell the IBM common stock in question for its own account, which Derivium in fact did."

- Judge Holmes's concurring opinion emphasized that the majority's test for a sale was too broad and could be applied to treat too wide a range of collateralized nonrecourse loan arrangements as sales. He concluded that the majority erred in treating the taxpayer's transfer of the stock to Derivium and Derivium's subsequent sale of the stock as one integrated transaction, because Derivium had represented to its customers that it would hold the stock and never told them of the quick sale. Instead, he would have treated Derivium's sale of the stock as the event triggering recognition by the taxpayer, under the *Tufts* principle that "when a nonrecourse liability is discharged by sale of collateral, the borrower must recognize income at that point – the amount realized is the amount of nonrecourse liability discharged as a result of the sale," since Reg. § 1.1001-2(a)(4)(i) provides that "the sale . . . of property that secures a nonrecourse liability discharges the transferor from the liability." He recognized that under his analysis, "the tax consequences to Calloway would be remarkably similar to those flowing from the result reached by the majority."

- The Tax Court majority opinion noted in a footnote that other cases involving Derivium transactions are pending in the Tax Court. From 1998 to 2002 Derivium engaged in approximately 1,700 similar transactions involving approximately $1 billion. The Government estimated the total tax loss associated with Derivium's scheme to be approximately $235 million.

- *Nagy v. United States*, 104 A.F.T.R.2d 2009-7789, 2010-1 U.S.T.C. ¶ 50,177 (D. S.C. 2009), *and United States v. Cathcart*, 104 A.F.T.R.2d 2009-6625, 2009-2 U.S.T.C. ¶ 50,658 (N.D. Calif. 2009) held, in § 6700 penalty cases, that the 90-percent stock-loan-program transactions offered by Derivium were sales of securities, not bona fide loans.

- District Court had enjoined Derivium Capital USA from promoting its 90 percent loan program. United States v. Cathcart, 105 A.F.T.R.2d 2010-1293 (N.D. Calif. 3/5/10).

a. And the Eleventh Circuit teaches even more about how to distinguish sales from loans in affirming the Tax Court. Calloway v. Commissioner, 691 F.3d 1315 (11th Cir. 8/23/12). In an opinion by Judge Ripple, the Eleventh Circuit affirmed the Tax Court's decision, essentially following the rationale of the Tax Court's majority opinion. Like the Tax Court, the Court of Appeals considered the *Grodt & McKay* factors to determine whether there had been a transfer of the benefits and burdens of ownership, which would thereby constitute a "sale," while pointing out that "'[N]one of these factors is necessarily controlling; the incidence of ownership, rather, depends upon all the facts and circumstances,'" citing *H.J. Heinz Co. & Subsidiaries v. United States*, 76 Fed. Cl. 570, 582 (2007). The Court of Appeals also considered the somewhat overlapping factors applied by the Tax Court in *Dunne v. Commissioner*, T.C. Memo 2008-63 specifically with respect to ownership of stock:

(1) Whether the person has legal title or a contractual right to obtain legal title in the future;

(2) whether the person has the right to receive consideration from the transferee of the stock;

(3) whether the person enjoys the economic benefits and burdens of being a shareholder;

(4) whether the person has the power to control the company;

(5) whether the person has the right to attend shareholder meetings;

(6) whether the person has the ability to vote the shares;

(7) whether the stock certificates are in the person's possession or are being held in escrow for the benefit of that person;

(8) whether the corporation lists the person as a shareholder on its tax returns;

(9) whether the person lists himself as a shareholder on his individual tax return;

(10) whether the person has been compensated for the amount of income taxes due by reason of the person's shareholder status;

(11) whether the person has access to the corporate books; and

(12) whether the person shows by his overt acts that he believes he is the owner of the stock.

- Applying the *Grodt & McKay* factors, as "refined" by *Dunne*, the court concluded that the most relevant factors "firmly" established that the transaction was a sale. Notwithstanding their labels, the agreements as a whole made it clear that during the period of time covered by the "loan." Derivium owned the stock. The court looked to its precedents under which "'the characteristics typically associated with "stock" are that it grants 'the right to receive dividends contingent upon an apportionment of profits'; is negotiable; grants 'the ability to be pledged or hypothecated'; 'confer[s][ ] voting rights in proportion to the number of shares owned'; and has 'the capacity to appreciate in value.'" When the taxpayer transferred the stock to Derivium pursuant to the agreements, "he ceded these rights of stock ownership to Derivium." Other *Grodt & McKay* benefits and burdens test factors also led to the conclusion that the transaction was a sale. The agreements granted "Derivium the right to possess the stock, the equity in the stock, and the right to receive the profits from either holding or disposing of the stock;" that the loan was nonrecourse assured that the risk of loss was shifted entirely to Derivium.

- The Court of Appeals rejected the approach taken by Judge Halpern in his concurring opinion, concluding that "Judge Halpern's approach risk[ed] transforming, for income tax purposes, all interests secured by stock into sales of stock." It also rejected the approach taken by Judge Holmes in his concurring opinion, concluding that "Judge Holmes's test could result in understatements of income when taxpayers have absolutely no way to determine that a taxable event has occurred."

b. Devious Derivium strikes again. Raifman v. Commissioner, T.C. Memo. 2012-228 (8/7/12). The taxpayer transferred stock to Derivium under its infamous "90% Stock Loan" program. Following *Calloway v. Commissioner*, 135 T.C. 26 (2010), the Tax Court (Judge Wells) granted the IRS's motion for summary judgment that the transactions were sales and not loans, but denied the IRS's motion for summary judgment on the taxpayer's claim for a theft loss deduction, concluding that genuine issues of material fact remained regarding whether the taxpayer was entitled to a theft loss deduction for the amount of the value of the options they purchased from Derivium. The taxpayer's affidavit alleged that Derivium misrepresented the nature of the transaction because Derivium never engaged in a plausible hedging strategy, but rather appeared to be massively betting that the price of all of its clients' stocks would fall, "hedged" only by a Ponzi scheme, and that the taxpayer relied on Derivium's misrepresentations when he entered into the 90% Stock Loan program by which he was defrauded. The instant case is distinguishable from prior Derivium cases in that none of the prior cases considered the taxpayer's attempt to exercise the rights to a return of the collateral after the maturity dates.

5. This case disproves the old adage "you can't lose for trying." Sollberger v. Commissioner, 691 F.3d 1119 (9th Cir. 8/16/12). The taxpayer entered into an agreement with Optech pursuant to which he transferred floating rate notes (FRNs) worth approximately $1 million to Optech in return for a nonrecourse loan of 90 percent of the value of the FRNs. Under the agreement Optech had the right to receive all dividends and interest on the FRNs, and the right to sell the FRNs during the loan term without Sollberger's consent. Optech did not hold the FRNs as collateral for the loan, but immediately sold the FRNs and transferred 90 percent of the proceeds to the taxpayer. The taxpayer treated the transaction as a loan rather than as a sale. The Ninth Circuit (Judge Smith) affirmed the Tax Court's holding (T.C. Memo. 2011-78) that the transaction was a sale. The court stated:

> Although the transaction took the form of a loan, Sollberger transferred the FRNs to Optech, and gave Optech the right to sell the FRNs (which Optech promptly exercised), to transfer the registration of the FRNs into its own name, and to keep all interest due from the FRNs. Sollberger would not be personally liable if he did not make payments on the loan since it was nonrecourse. . . . Nonrecourse financing, which is sometimes viewed as an "indicator of a sham transaction," *Sacks v. Comm'r*, 69 F.3d 982, 988 (9th Cir. 1995), placed Sollberger more in the position of a seller than a debtor. Nowhere in the Master Agreement or the Loan Schedule did Sollberger promise to repay the money "lent" to him. Instead, Optech merely agreed to return the FRNs if Sollberger repaid the loan at the end of the seven-year loan term, thereby giving Sollberger the option of repurchasing the FRNs in seven years, but not requiring him to do so. Thus, the transaction was more akin to an option contract, whereunder the FRNs were sold, but the seller retained a call option to reacquire them after seven years, if he elected to do so, than a true loan. . . .
>
> Sollberger's and Optech's conduct also confirms our conclusion that the transaction was, in substance, a sale. Although interest accrued on the loan, Sollberger stopped receiving account statements and making interest payments after the first quarter of 2005, less than one year into the seven-year loan term. Thus, neither Sollberger nor Optech maintained the appearance that a genuine debt existed for long. The total amount that Sollberger paid to Optech was *de minimis* compared to the size of the loan. The FRNs were also sold before Sollberger received the loan from Optech, which suggests that Optech funded the majority of the "loan amount" with the proceeds received from the sale of the FRNs. The apparent lack of any ability or intention by Optech to hold the FRNs as collateral to secure repayment of the loan further buttresses our conclusion that the transaction was merely a sale in the false garb of a loan.

- The court also rejected the taxpayer's argument that the transaction came within the § 1058 safe harbor for securities lending transactions because the requirements of that section clearly had not been met.

6. The Cap Gemini exchange cases:

a. Gain is recognized on an exchange even if the taxpayer didn't yet have what she got and she might not have gotten to keep it. United States v. Culp, 99 A.F.T.R.2d 2007-618 (M.D. Tenn. 12/29/06). The government was granted summary judgment in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The court held that the open transaction doctrine was not applicable. If a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions.

b. The Seventh Circuit affirmed taxable exchange treatment for an E&Y consulting partner in a Capgemini exchange. United States v. Fletcher, 562 F.3d 839 (7th Cir. 4/10/09),

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aff'g 101 A.F.T.R.2d 2008-588 (N.D. Ill. 1/15/08). In this 2000 exchange of taxpayer's partnership interest in E&Y for restricted stock of Capgemini, the Seventh Circuit (Judge Easterbrook) affirmed the summary judgment award to the government in this erroneous refund suit, and in the process "Fletcherized"[2] the E&Y consulting partner involved because she initially took the position of the parties to the transaction that all of the Capgemini shares received vested in the year 2000 [the year of the exchange], but after the stock declined in value took the position that she received income in 2000 only to the extent of cash she received in that year and the remainder of her income was recognized in 2003 [when the stock was worth less than one-fifth of its 2000 value].

- Judge Easterbrook did not appreciate the argument that she signed the "consulting partner transaction agreement" [which provided for taxable gain in 2000] only because she was afraid she would be fired if she did not do so. Both the district court and the Seventh Circuit held that under either *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), or the alternative "strong proof" test, taxpayer was bound by the agreement she signed. he stated that:

> Fletcher argues that she didn't "really" agree to the structure that Ernst & Young and Cap Gemini (and most of her partners) wanted in 2000. If she had voted no and refused to sign, she maintains, she would have been excluded from the economic benefits and might have been fired. If this is so, then she had a difficult choice to make; it does not relieve her of the choice's consequences. Hard choices may be gut-wrenching, but they are choices nonetheless. Even naïve people baffled by the fine print in contracts are held to their terms; a sophisticated business consultant who agrees to a multi-million-dollar transaction is not entitled to demand the deal's benefits while avoiding its detriments. The argument that Fletcher can avoid the terms as a matter of contract law is frivolous. All that matters now are the tax consequences of the contracts she signed.

- Judge Easterbrook concluded:

> The more likely it is that the conditions will be satisfied, and all restrictions lifted, the more sensible it is to treat all of the stock as constructively received when deposited in the account. To see this, suppose that the parties had wanted to defer the recognition of income and had put $2.5 million in each partner's account, with the condition that the whole amount would be forfeited if the temperature in Barrow, Alaska, exceeded 80 [degrees] F on January 1, 2005. Would the remote possibility of an Arctic heat wave enable the partners to defer paying taxes? Surely not. See *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008). If, on the other hand, the parties agreed that the ex-partners would receive $ 2.5 million only if the temperature in Barrow on January 1, 2005, exceeded 80 [degrees] F, then none of the partners would constructively receive income in 2000; everything would depend on events in 2005.
>
> The sort of contingencies that could lead to forfeitures were within the ex-partners' control. That implies taxability in 2000, for control is a form of constructive possession. And the agreement to discount the stock by only 5% tells us that the parties deemed forfeitures unlikely. Fletcher's acknowledgment that the risk of forfeiture was small shows that the conditions of constructive receipt in 2000 have been satisfied.
>
> Thus although we agree with Fletcher that the ex-partners are entitled to contest the tax treatment called for by the 2000 contracts, we hold that the shares are

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[2] Horace Fletcher (1849–1919), a health food faddist, argued that food should be chewed thirty-two times before being swallowed. "Nature will castigate those who don't masticate."

taxable in 2000 at their value on the date of deposit to the accounts at Merrill Lynch. Income was constructively received in that year not because the contract said that everyone would report it so to the IRS, but because the parties were *right* to think that this transaction's actual provisions made the income attributable to 2000. That the price of Capgemini stock dropped in 2001 and later does not entitle the parties to defer the recognition of income. Fletcher must repay the refund (and amend her returns for later years to reflect receipt of the income in 2000).

c. Ex-post recharacterization is not an option for taxpayers. United States v. Bergbauer, 602 F.3d 569 (4th Cir. 4/16/10). The Fourth Circuit affirmed a summary judgment for the government in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of Cap Gemini, a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The taxpayer initially reported that all of the Cap Gemini shares received vested in the year 2000 (the year of the exchange), but after the stock declined in value took the position that income was realized in 2000 only to the extent of cash received in that year and the remainder of the income was recognized in 2003 (when the stock was worth less than one-fifth of its 2000 value). The court held that if a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions. Furthermore, the court refused to accept the taxpayer's argument that the transaction could be recast into a form different than that which it had taken.

> To put it plainly, we have bound taxpayers to "the 'form' of their transaction" when they attempt to recharacterize an otherwise valid agreement bargained for in good faith. [citation omitted] We have also refused to entertain arguments "that the 'substance' of their transaction triggers different tax consequences." [citation omitted] This precept not only maintains the vital public policy of enforcing otherwise valid contracts, but also assures the reliability of agreed tax consequences to the public fisc. . . .
>
> There is no "disparity" in allowing "the Commissioner alone to pierce formal" agreements as "taxpayers have it within their own control to choose in the first place whatever arrangements they care to make." [citation omitted]

- Earlier cases that reached the same result for other taxpayers involved in the same transaction include *United States v. Fletcher*, 562 F.3d 839 (7th Cir. 4/10/09); *United States v. Culp*, 99 A.F.T.R.2d 2007-618, 2007-1 U.S.T.C. ¶50,399 (M.D. Tenn. 12/29/06); and *United States v. Nackel*, 105 A.F.T.R.2d 2010-474 (C.D. Cal. 10/20/09).

d. Judge Dyk stuck his finger into the Cap Gemini pie and pulled out a constructive receipt plum. Hartman v. United States, 694 F.3d 96 (Fed. Cir. 9/10/12). This Cap Gemini case was decided in favor of the government, as were all of the other Cap Gemini cases. The Federal Circuit (Judge Dyk) rejected the government's argument that taxpayer was bound under *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), by his agreement to recognize for federal income tax purposes in the year 2000 all the shares of Cap Gemini that were placed in escrow for him in that year because *Danielson* was limited to situations where "a taxpayer challenges express allocations of monetary consideration." Instead, Judge Dyk found that taxpayer was in constructive receipt of all the Cap Gemini stock that was received for him in exchange for his E&Y partnership interest even though the stock was placed into an escrow account and he could not receive the stock until subsequent years – subject to the risk of forfeiture should he sooner voluntarily terminate his employment with Cap Gemini.

7. Extended tax-free capital gains for "small" C corporation stock. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act extends help to qualified small business stock. Gain realized on a sale or exchange of qualified small business stock under § 1202, which was acquired after the date of enactment of the 2010 Small Business Act [9/27/10] and before 1/1/11 [subsequently extended to "before 1/1/12"], was subject to 100 percent exclusion from gross income. The 2012 Act, § 324(b), extends the 100 percent exclusion to stock acquired before 1/1/12 to before 1/1/14. Gain attributable to qualified small business stock acquired between 9/27/10 and 1/1/14 is not treated as an AMT preference item. The exclusion is applicable to noncorporate shareholders who acquire stock at original issue and hold the stock for a minimum of five years. Under the former 50 percent and 75 percent exclusions, included gain was subject to tax at the 28 percent capital gains rates. The amount of excluded gain attributable to any one corporation is limited to the greater of ten times the taxpayer's basis in a corporation's stock sold during the taxable year or $10 million reduced by gain attributable to the corporation stock excluded in prior years. Qualified small business stock is stock issued by a C corporation engaged in the active conduct of a trade or business with gross assets (cash plus adjusted basis of assets) not in excess of $50 million.

8. Application of the step transaction doctrine obviates the need to apply a statutory anti-abuse rule. G.D. Parker, Inc. v. Commissioner, T.C. Memo. 2012-327 (11/27/12). A Panamanian corporation (Vicmar) owned a minority interest in a Peruvian telecommunications corporation (Tele2000). The stock had a built-in loss of over $12 million. In March 2004 BellSouth, the owner, though a subsidiary of the majority interest, agreed to sell its stock of Tele2000 to Telefonica (a Spanish corporation). Telefonica's announced plan was to purchase 100 percent of Tele2000. During the period between March 2004 and December 21, 2004, Vicmar took steps to transfer its stock of Tele2000 to the taxpayer, G.D. Parker, Inc. On December 16, the parties, including the taxpayer, entered into a share transfer and settlement agreement, and the sale was finalized on 12/21/04. The taxpayer was made a party to the share transfer agreement at the last minute after the sole shareholder of Vicmar represented to Bell South and Telefonica that the taxpayer was the owner of the Tele2000 shares. Before the last-minute representation, BellSouth's representative was unaware of the taxpayer's existence. Applying the end result version of the step transaction doctrine, the Tax Court (Judge Haines) held that Vicmar, the Panamanian corporation, not the taxpayer U.S. corporation, was the true seller of the stock and disallowed the taxpayer's loss deduction.

> [I]t is clear from the record that, from the start, the acquisition of the Tele2000 shares by petitioner and the subsequent sale to Telefonica were really steps of a single transaction intended to be taken for the purpose of reaching the ultimate result. Those steps constituted part of a prearranged plan to have Telefonica obtain the Tele2000 shares while having the capital loss shifted to petitioner. Had Telefonica acquired the shares directly from Vilanova, this shift in the capital loss would not have occurred, and petitioner would have been obligated to report a capital gain rather than a capital loss that it could carry back to prior years. Petitioner may not avoid this result by employing

mere formalisms thinly disguised to mask its true intentions. . . . Hence under the end-result test petitioner's ownership of the Tele2000 shares must be ignored, with Telefonica being viewed as having acquired the shares from Vilanova.

- The IRS also argued that § 362(e), which would have reduced the taxpayer's basis in the stock to fair market value, applied, but Judge Haines concluded that there was no need to reach a decision with respect to § 362(e) because under the step transaction doctrine there was no transfer of the stock from Vicmar to the taxpayer for income tax purposes.

9. The taxpayer passed the benefits and burdens of ownership to his wholly owned corporation, so he sold the property and recognized a gain. Gaggero v. Commissioner, T.C. Memo. 2012-331 (11/29/12). In the early 1990s, the taxpayer bought, for $3 million, and moved into a rundown beach house in Malibu that was renovated into a splendid mansion while he lived in it as his primary residence. Before renovations in 1991, he entered into a Land Contract Purchase and Sale Agreement and a Development Contract with BCC, a real estate development corporation that was wholly owned by the taxpayer. The essence of the deal was that BCC would provide the development services and BCC would receive an equal share in any increase in the property's value between the time the contract was signed and the time the property was sold to a third party, even though the taxpayer would pay most of the costs of the project. BCC would receive its interest if it completed its work. The project was completed in 1997 and the residence was sold for $9.6 million. The taxpayer reported a receipt of $6.6 million, but claimed that pursuant to former § 1034 none of it was recognizable because he purchased a new residence for $6.7 million. BCC reported ordinary income of $3 million. The IRS contended that the taxpayer never sold any interest in the residence to BCC and that he realized $9 million on its sale and should have reported a $2.9 million gain. The Tax Court (Judge Holmes) engaged in an extensive factual inquiry of whether the benefits and burdens of ownership in a partial interest in the residence had passed to BCC prior to the sale to the ultimate purchaser, and concluded that because benefits and burdens of ownership had been transferred, a partial ownership had passed from the taxpayer to BCC prior to the sale to the ultimate purchaser. That the taxpayer continued to maintain the property as his primary residence did not alter that fact. Accordingly, a sale had occurred. However, the sale from the taxpayer to BCC occurred in 1997, when BCC's interest vested, and the amount realized on that sale was $3 million; the remaining $6.6 million was realized by the taxpayer on the sale the remaining interest. Since he realized $9.6 million of the sale of his residence and purchased a replacement residence for only $6.7 million, he should have recognized a gain of $2.9 million. However, the court did not uphold penalties, finding that the taxpayer relied in good faith on his tax advisor.

B. Interest, Dividends, and Other Current Income

1. What does "traded on an established securities market" mean in the Internet era? REG-131947-10, Property Traded on an Established Market, 76 F.R. 1101 (1/7/11). Under the OID rules, if a debt instrument is issued for stock or other debt instruments (or other property) that is traded on an established securities market (often referred to as "publicly traded"), the issue price of the debt instrument is the fair market value of the stock or other property. Similarly, if a debt instrument issued for property, such as another debt instrument, is traded on an established securities market, the issue price of the debt instrument is the fair market value of the debt instrument. See Reg. § 1.1273-2(c). Among other issues, a debt-for-debt exchange (including a significant modification of existing debt) in the context of a work-out may result in a reduced issue price for the new debt, which generally would produce (1) COD income for the issuer (i.e., debtor), (2) a loss to a holder (i.e., creditor) whose basis is greater than the issue price of the new debt, and (3) OID that must be accounted for by both the issuer and the holder of the new debt. The Treasury has published proposed regulations that are intended to simplify and clarify the determination of when property is traded on an established market. Prop. Reg. § 1.1273-2(f)(1) would identify four ways for property to be traded on an established market: (1) the property is publicly traded on an exchange (as defined), which is relatively unusual for debt instruments other than corporate bonds; (2) a sales price for the property is reasonably available – it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments" ("a sale that is reported electronically at any time in the 31-day time period, such as in the Trade Reporting and Compliance Engine ("TRACE") database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers"); (3) if a firm price quote to buy or sell the property is available; or (4) a price quote (other than a firm quote) that meets certain standards set forth in the regulations is provided by a dealer, a broker, or a pricing service (an indicative quote). In all four cases, the time for determining whether the property is publicly traded is the 31-day period ending fifteen days after the issue date of the debt instrument. There would be an exception for "small debt issues – those below $50,000,000. The regulations will apply to debt instruments that have an issue date on or after the promulgation of final regulations.

a. Finalized with some important changes. T.D. 9599, Property Traded on an Established Market, 77 F.R. 56533 (9/13/12). Final Reg. § 1.1273-2(f)(1) substantially follows the framework of the proposed regulations but provides only three rules for determining that property is traded on an established market. Reg. § 1.1273-2(f)(1) provides that property is traded on an established market if at any time in the 31-day time period ending 15 days after the issue date of a debt instrument: (1) a sales price for the property is reasonably available – it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments (a sale that is reported electronically such as in the Trade Reporting and Compliance Engine (TRACE) database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers); (2) a firm price quote to buy or sell the property is available; or (3) a price quote (other than a firm quote) that meets certain standards set forth in the regulations, is provided by a dealer, a broker, or a pricing service (an "indicative quote"). Very significantly, Reg. § 1.1273-2(f)(6) provides that a debt instrument will not be treated as traded on an established market if at the time the determination is made the outstanding stated principal amount of the issue that includes the debt instrument does not exceed $100 million (rather than $50 million as provided in the proposed regulations). The other significant change made in the final regulations is to require that the issue price be reported consistently by issuers and holders.

- The regulations generally apply to a debt instrument issued on or after 11/13/12.

- According to the preamble:

> The final regulations dispense with the category of exchange listed property because the small amount of debt that is listed rarely actually trades over the exchange. Moreover, although stock, commodities, and similar property are commonly listed on and traded over a board or exchange, such property typically will be the subject of frequent sales or quotes and would be covered in a separate category of publicly traded property. A debt instrument that is issued for stock, commodities, or similar exchange traded property is therefore tested under the rule for property where there is a sales price or quote within the 31-day period ending 15 days after the issue date of the debt instrument. Eliminating the category of property listed on an exchange also eliminates the need for the de minimis trading exception in the proposed regulations, which was intended to exclude property that is listed on an exchange but trades in a negligible quantity.

2. Ouch! He got nothing in pocket, but his realized income was $29,093.30. Brown v. Commissioner, 693 F.3d 765 (7th Cir. 9/11/12). The taxpayer owned an insurance policy on which he had borrowed money in excess of the cash surrender value. At the time that the policy was cancelled by the insurance company, the taxpayer had paid $44,205.00 in premiums, but the insurance company had applied $31,063.30 of policy dividends to the purchase of additional insurance above the $100,000 face value of the policy, and $4,869.94 of dividends had been applied to pay premiums and repay policy loans. The additional paid up life insurance had been surrendered for its cash value to repay policy loans prior to the cancellation of the base $100,000 policy. The Seventh Circuit (Judge Posner) affirmed a Tax Court decision holding that the taxpayer's investment in the contract had been reduced from $44,205.00 to $8,271.76 as a result of the application of $35,933.24 of dividends as described. Accordingly, because the cash surrender value of the policy, which was applied against policy loans when it was cancelled was $37,365.06, taxpayer realized income of $29,093.30 ($37,365.06 - $8,271.76).

3. **Exempt financing for New York Liberty Zone bonds extended.** The 2012 Taxpayer Relief Act, § 328, extends the issue date for exempt New York Liberty Bonds to bonds issued before January 1, 2014.

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

1. **Judge Goeke lets the taxpayer get away with a like-kind exchange claim where the replacement property was used as taxpayer's principal residence.** Reesink v. Commissioner, T.C. Memo. 2012-118 (4/23/12). The taxpayer disposed of an undivided one-half interest in an apartment building (along with his estranged brother) and acquired a single family home (the Laurel Lane property), which was originally acquired as investment or rental property, but into which the taxpayer and his family moved, as their principal residence, eight months after the acquisition. According to the Tax Court (Judge Goeke), the only issue in the case relating to whether the acquisition and disposition of the two properties qualified as a like kind-exchange was whether the taxpayer held the acquired property "with investment intent at the time of the exchange." Based on a number of factors, including the taxpayer's efforts to rent the acquired property, that he did not sell his principal residence in another city until six months after the acquisition, and the testimony of the taxpayer's estranged brother that the taxpayer did not plan to relocate until his son was finished with high-school, which he was not at the time of the transaction, Judge Goeke held that the taxpayer had acquired the property for investment.

2. **Rental property occupied by the taxpayer's son was investment property, not personal-use property.** Adams v. Commissioner, T.C. Memo. 2013-7 (1/10/13). The taxpayer engaged in a deferred like-kind exchange through an intermediary in which he surrendered a property held for rental and acquired a new residential property that was dilapidated and in need of rehabilitation. The taxpayer and his son entered into an agreement whereby the son and his family could live in the new house after renovations. The son and his family worked on the house an aggregate of 60 hours per week for three months before moving in. The son and his family bore all of the rehabilitation expenses; their services were worth $3,600. After three months of work, the son's family moved in, resided in the house for three years, and paid rent that was a few hundred dollars per month less than the fair rental value. The IRS took the position that the transaction was not a § 1031 like-kind exchange because the taxpayer acquired the new house for personal purposes – i.e., "with the intention of letting his son and family live there at below market rent" – and that the taxpayer thus must recognize gain on the sale. The Tax Court (Judge Morrison) found that the taxpayer had acquired the new house for investment purposes and that the transaction thus qualified as a § 1031 like-kind exchange. Furthermore, the limitations on deductions imposed by § 280A did not apply to the new house rented to the son. Pursuant to § 280A(d)(2), a taxpayer is treated as using a dwelling unit during the taxable year as a residence if the taxpayer rents the dwelling unit to a family member, unless the taxpayer rents the dwelling unit to the

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family member "at a fair rental" and for use as that family member's principal residence. The son used the residence as his principal residence and, although the $1,200 per month cash rent was slightly below market, it was fair rent considering the work that the son had performed with respect to the house. Thus the § 280A(a) prohibition of deductions for dwelling units used as residences did not apply.

3. Swapping both a personal residence and business property for a new personal residence and business property invokes both § 1031 and § 121 and provides a computational challenge. Yates III v. Commissioner, T.C. Memo 2013-28 (1/24/13). Through a qualified intermediary, the taxpayers exchanged a property that qualified as a principal residence under § 121 and a business property for a new principal residence and two business properties. The issues in the case dealt mainly with the proper valuations of the properties, which determined the amount of gain realized that was not sheltered by § 1031; and there is nothing noteworthy about the valuation determinations. The important point of the case is that the Tax Court (Judge Goeke) applied Reg. § 1.1031(j)-1(a)(1), which provides that where multiple properties are transferred in a like-kind exchange, the properties are separated and arranged for analysis into "exchange groups" based on shared characteristics. A "residual group" is created if the aggregate fair market value of the properties transferred in all of the exchange groups qualifying for § 1031 treatment differs from the aggregate fair market value of the properties received in all the exchange groups. Both residences were treated as part of the residual group, with the new residence treated as boot, but § 121 applied to provide nonrecognition (for up to $500,000) of gain on the exchange of the old personal residence for a new one. The exact computations were left to be made under Rule 155.

F. Section 1033

G. Section 1035

H. Miscellaneous

1. It takes a paper trail to prove that stock is "qualified small business stock," but a bribery attempt by taxpayer's representative [an enrolled agent] during the audit was not sufficient to support a fraud penalty. Holmes v. Commissioner, T.C. Memo. 2012-251 (8/30/12). Section 1045 provides for elective nonrecognition of capital gain on the sale of "qualified small business stock," as defined in § 1202, if the stock has been held for more than six months, and if the taxpayer purchases replacement qualified small business stock within 60 days of the date of the sale. The taxpayer's efforts to defer gain on the sale of stock in this case failed. The Tax Court (Judge Halpern) held that § 1045 did not apply because, among other reasons, the taxpayer failed to prove that (1) as required by § 1202(c)(1)(B), he acquired the stock at its original issue in exchange for money, or (2) as required by § 1202(d)(1)(A) and (B), the corporation's aggregate gross assets immediately after the stock issuance did not exceed $50 million. The taxpayer offered no documentary evidence, such as stock certificates or book entries from the corporation, indicating from whom he acquired the stock. Nor did the taxpayer introduce into evidence corporate balance sheets or other financial statements showing the amount of cash and property held by the corporation before and immediately after each date he acquired stock.

- Even though the taxpayer's return preparer/representative during the audit, an enrolled agent, attempted to bribe the Revenue Agent conducting the audit, behavior that Judge Halpern described as "highly inappropriate," such behavior was not sufficient to support imposition of a fraud penalty, because, among other facts, the record was "devoid of evidence indicating that Mr. Afshar's actions towards Agent Mahamoud, while highly inappropriate, were part of [taxpayer's] scheme of tax evasion initiated at the time of filing the subject tax returns. As we have stated above, it seems more likely that Mr. Afshar's actions were a continuation of his attempt at mitigating the tax preparation errors."

- **Compare: The taxpayer's conduct was not fraudulent, but maybe**

he wasn't an innocent babe in the woods either. The return was fraudulent even though the taxpayer did not know it. Allen v. Commissioner, 128 T.C. 37 (3/5/07). Judge Kroupa held that the statute of limitations for a fraudulent return is extended under § 6501(c)(1), even though it was solely the return preparer, rather than the taxpayer, who had the intent to evade tax. The taxpayer was a truck driver who filed timely returns for the years at issue. He gave his Form W-2, 401(k) statement, mortgage interest statement, and other relevant documents to his return preparer (Goosby) who prepared the returns and filed them. As prepared by Goosby, the returns claimed false and fraudulent itemized deductions for charitable contributions, meals and entertainment, and pager and computer expenses, as well as various other expenses. The taxpayer received complete copies of the returns for the years at issue after they had been filed, but he did not file any amended tax returns. Judge Kroupa reasoned as follows:

> We do not find it unduly burdensome for taxpayers to review their returns for items that are obviously false or incorrect. It is every taxpayer's obligation. Petitioner cannot hide behind an agent's fraudulent preparation of his returns and escape paying tax if the Government is unable to investigate fully the fraud within the limitations period.

- She further noted that the IRS was seeking to collect only the deficiency (and interest) from the taxpayer.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. This one hits parents of special needs children the hardest. Wouldn't it just be easier to have a government-run national health care program? Then we could have rationing by queue. Notice 2012-40, 2012-26 I.R.B. 1046 (5/30/12). This Notice provides guidance on the limits in § 125(i) on salary reduction contributions to health flexible spending arrangements, effective for cafeteria plan years beginning after 12/31/12, and requests comments on possible modification to the "use-or-lose" rule in the proposed § 125 regulations. The Notice provides that the $2,500 limit does not apply for plan years that begin before 2013 and plans may adopt the required amendments to reflect the $2,500 limit at any time through the end of calendar year 2014. (Indexing of the $2,500 limit applies to plan years beginning after 12/31/13.) For plans providing a grace period (which may be up to two months and 15 days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the $2,500 limit for the subsequent plan year.

2. Did the Tax Court really mean to deny a deduction for a taxable fringe benefit? DKD Enterprises, Inc. v. Commissioner, T.C. Memo. 2011-29 (1/31/11). The Tax Court (Judge Chiechi) upheld the IRS's denial of the corporation's deduction of the cost of medical insurance premiums for a policy covering its employee/sole shareholder because the corporation "failed to carry its burden of establishing that it had in effect during any of the years at issue a sickness, hospitalization, medical expense, or similar benefit plan for employees." For that same reason, the individual shareholder/employee was not entitled to exclude the amount of the premiums under either § 105 or § 106.

- Notably, the court did not expressly recharacterize the premium payment as a constructive dividend.

a. And the Eighth Circuit also seems to be smoking suspicious substances in analyzing this issue. DKD Enterprises, Inc. v. Commissioner, 685 F.3d 730 (8th Cir. 7/17/12). The Eighth Circuit, in an opinion by Judge Riley, affirmed "[b]ecause the tax court permissibly found DKD failed to prove the payments were made pursuant to a pre-determined plan for the benefit of employees." Although acknowledging that under Reg. § 1.105-5, "a plan may cover a single employee or limited class of employees; need not be in writing; and need not be enforceable by the employee," the court held that there was no "plan" because while the taxpayer "testified DKD 'paid [her] quarterly medical insurance,' paying approximately the same amount for her insurance in 2003, 2004, and 2005," she "did not testify these payments were made according to a pre-determined 'plan' intended to benefit employees."

- We wonder whether the court's reasoning indicates that it thought twelve consecutive payments for medical insurance were made by accident. "Plan" versus "accident;" are there any other alternatives?

3. **Premiums for corporate welfare benefit plans for principal owners fail the smell test, with penalties.** Curcio v. Commissioner, 689 F.3d 217 (2d Cir. 8/9/12). In consolidated cases involving three different subchapter S corporations, Judge Chin upheld the Tax Court's denial of deductions for premiums paid to maintain welfare benefit plans consisting of individual life insurance policies for selected employees, the so-called Benistar 419 plan, a multi-employer welfare benefit trust. The plan allowed the policy beneficiaries to withdraw the life insurance policies from the plan and obtain the net surrender value. In each case the court found that the life insurance policies were provided to key employees (shareholders) for the personal benefit of the employees (to fund a buy/sell agreement, to provide retirement planning, and to divert business profits). While the court acknowledged that contributions to a welfare benefit plan may be deductible, in these cases the court indicated that the Tax Court did not err in finding that the contributions were not helpful for the development of the taxpayers' businesses and were made instead for the personal benefit of the S corporation shareholders. The court observed that the plan was designed to benefit the owners and their families, not the respective business entities. In addition to upholding tax deficiencies representing increased pass-through income to the taxpayers, the court upheld § 6662(a) accuracy-related penalties, again indicating that the Tax Court did not err in concluding that the taxpayers were negligent and acted in disregard of the tax rules and regulations. The court further rejected the taxpayer's assertion that they relied on the advice of their accountants noting that there was little reason for the taxpayers to believe that their accountants were experts in the tax treatment of welfare benefit plan contributions or that the accountants had sufficiently researched the issue.

4. **Putin might be fighting American adoptions, but Congress likes adoptions.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 104, made permanent the Code § 137 exclusion for employer-provided adoption assistance. The maximum exclusion is $12,170 (adjusted for inflation), and the phase-out range is $182,520 to $222,520 (adjusted for inflation).

5. **This ruling is expressly for lactating mothers.** Announcement 2011-14, 2011-9 I.R.B. 532 (2/10/11). This announcement held that breast pumps and supplies that assist lactation are medical care under § 213(d) because "they are for the purpose of affecting a structure of the body of the lactating woman." The announcement did not refer at all to the health of the baby.

a. Making what was recently held to be a deductible medical expense into a mandatory freebee. A new mandate under Obamacare makes all this stuff mandatory for group plans, as well as miraculously free for the insureds. T.D. 9541, Medical Loss Ratio Reporting, 76 F.R. 46621 (8/3/11). Temp. Reg. § 54.9815-2713T(a)(1)(iv) requires coverage by all group plans of contraceptive, breast-feeding and many other services for women without co-pays and without deductibles. REG-120391-10, Medical Loss Ratio Reporting, 76 F.R. 46677 (8/3/11), promulgates identical proposed regulations. The effective date is 8/1/12.

b. **"[Obama says that] your little [Republican] friends are wrong. . . . Yes, Virginia, there is a Santa Claus."**[3] REG-120391, Coverage of Certain Preventive Services Under the

[3] "DEAR EDITOR: I am 8 years old.

Affordable Care Act, 78 F.R. 8456 (2/6/13). These proposed regulations would require that insurance companies for tax-exempt religious organizations, including hospitals, universities and schools, provide free contraceptive services to all women insured by them (including students at universities), but would provide that the insurance companies will be reimbursed for the costs of individual contraceptive-only

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"Some of my little friends say there is no Santa Claus.

"Papa says, 'If you see it in THE SUN it's so.'

"Please tell me the truth; is there a Santa Claus?

"Virginia O'Hanlon.

"115 West Ninety-Fifth Street."

Virginia, your little friends are wrong. They have been affected by the skepticism of a skeptical age. They do not believe except they see. They think that nothing can be which is not comprehensible by their little minds. All minds, Virginia, whether they be men's or children's, are little. In this great universe of ours man is a mere insect, an ant, in his intellect, as compared with the boundless world about him, as measured by the intelligence capable of grasping the whole of truth and knowledge.

Yes, Virginia, there is a Santa Claus. He exists as certainly as love and generosity and devotion exist, and you know that they abound and give to your life its highest beauty and joy. Alas! how dreary would be the world if there were no Santa Claus. It would be as dreary as if there were no Virginias. There would be no childlike faith then, no poetry, no romance to make tolerable this existence. We should have no enjoyment, except in sense and sight. The eternal light with which childhood fills the world would be extinguished.

Not believe in Santa Claus! You might as well not believe in fairies! You might get your papa to hire men to watch in all the chimneys on Christmas Eve to catch Santa Claus, but even if they did not see Santa Claus coming down, what would that prove? Nobody sees Santa Claus, but that is no sign that there is no Santa Claus. The most real things in the world are those that neither children nor men can see. Did you ever see fairies dancing on the lawn? Of course not, but that's no proof that they are not there. Nobody can conceive or imagine all the wonders there are unseen and unseeable in the world.

You may tear apart the baby's rattle and see what makes the noise inside, but there is a veil covering the unseen world which not the strongest man, nor even the united strength of all the strongest men that ever lived, could tear apart. Only faith, fancy, poetry, love, romance, can push aside that curtain and view and picture the supernal beauty and glory beyond. Is it all real? Ah, Virginia, in all this world there is nothing else real and abiding.

No Santa Claus! Thank God! he lives, and he lives forever. A thousand years from now, Virginia, nay, ten times ten thousand years from now, he will continue to make glad the heart of childhood. (The [New York] Sun, 9/21/1897, p. 1, unsigned, by Francis Pharcellus Church.)

policies by the government. However, HHS Secretary Sibelius stated that the taxpayers would not pay for these reimbursements either. Thus, services that cost $18,000 per woman would become free under Obamacare.

- Such is the magic power of compound interest.

B. Qualified Deferred Compensation Plans

1. Rev. Proc. 2013-12, 2013-4 I.R.B. 313 (12/31/12), *modifying and superseding* Rev. Proc. 2008-50, 2008-2 C.B. 464. This revenue procedure updates the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of §§ 401(a), 403(a), 403(b), 408(k), or 408(p) of the Code, but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits Plan Sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP").

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

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

- The proposed amendments are proposed to apply to property transferred on or after 1/1/13. Taxpayers may rely on the proposed regulations for property transferred after 5/30/12.

2. The IRS provides help to avoid messing up your § 83(b) election, but you still have to remember to file it on time, i.e., within 30 days. Rev. Proc. 2012-29, 2012-28 I.R.B. 49 (6/27/12). This Revenue Procedure provides sample language that may be used, but is not required to be used, for making a § 83(b) election. It also provides several examples of the consequences of making a § 83(b) election.

D. Individual Retirement Accounts

1. The "use a C corporation to increase IRA contributions" scam is struck down. Repetto v. Commissioner, T.C. Memo. 2012-168 (6/14/12). The Tax Court (Judge Marvel) imposed the 6 percent excess contribution tax under § 4973 for a scheme established by the taxpayers' CPA. The taxpayers formed two corporations, most of the stock of which was held by the taxpayers' newly formed IRAs. One of the two corporations was intended to provide office and support services, and the other to provide marketing and business development services to the taxpayers' construction and rental property businesses operated through an S corporation and LLC. The court indicated that the preponderance of the evidence supported a finding that the service agreements and the payments to the Roth IRA owned corporations "were nothing more than a mechanism for transferring value to the IRA." The court stated that the service agreements did not change the identity of the person providing services to the construction businesses, the taxpayers continued to do the work as they had done before the arrangement was structured, and the taxpayers provided no written documentation of the services provided. The court's conclusion was bolstered by the language of the engagement letter with the CPA, which supported the finding that payment of dividends to the Roth IRAs was the primary goal of the support agreements. The court determined that the amount contributed to the Roth IRA and the amount of excess contributions should be determined based on the fair market value of the Roth IRA at year end. The court rejected the IRS approach that would have treated payments to the corporations as distributions to the taxpayers who subsequently contributed the amounts to the Roth IRAs.

- In the consolidated cases the court also held that amounts distributed by the taxpayers' S corporation were to be treated as wages rather than distributions.

- Amounts paid for medical plans that benefited the taxpayers by the IRA-owned C corporations were disallowed as deductions by the corporations because the employment relationship with Mrs. Repetto was a sham.

- The taxpayers were liable for a 5 percent penalty for failure to file Form 5329 reporting excess contributions to their IRAs and that the taxpayers' reliance on the tax professionals who promoted the scheme was not reasonable.

- The taxpayers were liable for the 20 percent penalty of § 6662A incurred for an understatement attributable to a reportable transaction. The transaction was substantially similar to the listed transaction described in Notice 2004-8, 2007-1 C.B. 333, promulgated before the taxpayers filed returns involving the transaction. In addition, the taxpayers were held liable for the increased 30 percent penalty of § 6662A(c) for failing to file a disclosure of their participation in a listed transaction. Again the court found that taxpayers did not reasonably rely on the advice of independent tax professionals.

- The court revised the IRS computation of the understatement subject to penalties by holding that understatements attributable to wages paid by the taxpayers' S corporation and the disallowance of medical expense deductions were not related to the listed transaction.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. DOMA could be on its way to the Supreme Court. On the other hand, might this case lead to DOMA becoming the Twenty-Eighth Amendment? Not likely, unless it was left to the bigoted voters. Massachusetts v. United States Dept. of Health and Human Services, 682 F.3d 1 (1st Cir. 5/31/12), *aff'g* Gill v. Office of Personnel Management, 699 F. Supp. 2d 374 (D. Mass. 7/8/10). In an opinion by Judge Boudin, the First Circuit held that § 3 of the Defense of Marriage Act, 1 U.S.C. § 7, which limits the meaning of the word "marriage" to "a legal union between one man and one woman as husband and wife," and provides that "the word 'spouse' refers only to a person of the opposite sex who is a husband or wife" for purposes of all federal laws is an unconstitutional denial of equal protection in violation the equal protection principles embodied in the Due Process Clause of the Fifth Amendment. Joint return filing status under the Code was one of the issues addressed in the case, as well as government benefits available to married individuals, e.g., employee health benefits, social security benefits. The court further ordered:

> Anticipating that certiorari will be sought and that Supreme Court review of DOMA is highly likely, the mandate is stayed, maintaining the district court's stay of its injunctive judgment, pending further order of this court.

a. The Second Circuit agrees in a split decision. Windsor v. United States, 699 F.3d 169 (2d Cir. 10/18/12) (2-1), *cert. granted*, 184 L. Ed. 2d 527 (12/7/12). In an appeal from a grant of summary judgment in a tax refund suit by the District Court for the Southern District of New York, the Second Circuit (Chief Judge Dennis Jacobs) affirmed the grant of summary judgment to the surviving spouse of a same-sex couple that was married in Canada in 2007 and resided in New York at the time of her spouse's death in 2009 who was denied the benefit of the § 2056 marital deduction for federal estate tax on the ground that the Defense of Marriage Act violated the Equal Protection Clause for want of a rational basis.

- The court concluded that review of § 7 required heightened scrutiny because (A) homosexuals as a group have historically endured persecution and discrimination; (B) homosexuality has no relation to aptitude or ability to contribute to society; (C) homosexuals are a discernible group with non-obvious distinguishing characteristics, especially in the subset of those who enter same-sex marriages; and (D) the class remains a politically weakened minority. The circuit court further concluded that the class was quasi-suspect (rather than suspect) based on the weight of the factors and on analogy to the classifications recognized as suspect and quasi-suspect. The circuit court held that the rationale premised on uniformity was not an exceedingly persuasive justification for DOMA, and that DOMA was not substantially related to the important government interest of protecting the fisc.

- Judge Straub dissented on the following basic ground:

> The majority holds DOMA unconstitutional, a federal law which formalizes the understanding of marriage in the federal context extant in the Congress, the Presidency, and the Judiciary at the time of DOMA's enactment and, I daresay, throughout our nation's history. If this understanding is to be changed, I believe it is for the American people to do so. . . .
>
> At bottom, the issue here is marriage at the federal level for federal purposes, and not other legitimate interests. The Congress and the President formalized in DOMA, for federal purposes, the basic human condition of joining a man and a woman in a long-term relationship and the only one which is inherently capable of producing another generation of humanity. Whether that understanding is to continue is for the American people to decide via their choices in electing the Congress and the President. It is not for the Judiciary to search for new standards by which to negate a rational expression of the nation via the Congress.

2. Net investment income tax of 3.8 percent.[4] Section 1411 of the Code, added by the Health Care and Education Reconciliation Act of 2010, imposes a 3.8 percent tax on the net

[4] We thank Professor Bruce McGovern, South Texas College of Law for contributing this description of § 1411 and the regulations thereunder.

investment income of individuals, estates, and trusts in taxable years beginning after 12/31/12. For individuals (except nonresident aliens), the tax applies only to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income over a threshold amount. Section 1411(a)(1). The threshold amount is $250,000 for spouses filing a joint return or a surviving spouse, $125,000 for married individuals filing separate returns, and $200,000 for single taxpayers (including heads of household). Section 1411(b). These threshold amounts for individuals are not adjusted for inflation. Modified adjusted gross income is adjusted gross income increased by the amount of foreign earned income excluded under § 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). Section 1411(d). For estates and trusts, the tax is levied on the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income (as defined in § 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins for the tax year ($11,950 for 2013). Section 1411(a)(2). The tax does not apply to a trust that is tax-exempt under § 501, is a charitable remainder trust tax-exempt under § 664, or all of the unexpired interests of which are devoted to charitable purposes. Net investment income is investment income reduced by the deductions properly allocable to that income. Investment income is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (2) other gross income derived from any trade or business to which the tax applies, and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply. Section 1411(c)(1). The § 1411 tax applies to trade or business income from (1) a passive activity, and (2) trading financial instruments or commodities (as defined in § 475(e)(2)). Section 1411(c)(2). It does not apply to any other trade or business income. However, income on the investment of working capital is not treated as derived from a trade or business and is subject to tax under § 1411. Section 1411(c)(3). Gain or loss from the disposition of a partnership interest or stock in an S corporation is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Section 1411(c)(4). Thus there is a deemed basis adjustment that results in taking into account only the net gain or loss attributable to the entity's property that is not attributable to an active trade or business. Investment income does not include any distributions from a qualified retirement plan or any income subject to self-employment tax. Section 1411(c)(5)-(6). Unlike self-employment taxes, no part of the § 1411 tax is deductible in computing taxable income under Chapter 1. The tax on net investment income is subject to the estimated tax provisions. Section 6654(a).

a. Proposed regulations provide extensive guidance on the tax on net investment income. On 11/30/12, the Treasury Department issued proposed regulations regarding the § 1411 tax on net investment income. REG-130507-11, Net Investment Income Tax, 77 F.R. 72612 (12/05/12). Prop. Reg. § 1.469-11 is amended and Prop. Regs. §§ 1.1411-0 through 1.1411-10 have been are published to provide guidance under § 1411, regarding the 3.8 percent net investment income tax. The proposed regulations are proposed to be effective for tax years beginning after 12/31/13. The Treasury Department intends to issue final regulations during 2013. However, § 1411 is effective for tax years beginning after 12/31/12. Taxpayers may rely on the proposed regulations for purposes of complying with § 1411 until the effective date of the final regulations. The general principles underlying them are:

- *General provisions.* Section 1411 is the only provision in chapter 2A of subtitle A of the Code. Chapter 2A does not contain any other operational or definitional provisions. The proposed regulations provide that, except as otherwise provided, all Code provisions that apply for purposes of chapter 1 in determining taxable income as defined in § 63(a) also apply in determining the tax imposed by § 1411. Prop. Reg. § 1.1411-1(a).

- *Application to estates and trusts.* The proposed regulations provide as a general rule that the § 1411 tax applies to all estates and trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Code. Prop. Reg. § 1.1411-3(a)(1)(i). Accordingly, the § 1411 tax does not apply to trusts that are not classified as trusts under the check-the-box regulations (such as business trusts). It also does not apply to trusts that are exempt from taxes imposed by subtitle A of the Code. Prop. Reg. § 1.1411-3(b)(2)-(4). This is true even if the trust is subject to tax on its unrelated business taxable income. The proposed regulations clarify that grantor trusts are not subject to the tax. The grantor or other person who takes into account the grantor trust's income and deductions is treated as receiving and paying those items directly for purposes of calculating that person's liability for the § 1411 tax. Prop. Reg. § 1.1411-3(b)(5). Special computational rules apply to electing small business trusts and charitable remainder trusts. Prop. Reg. § 1.1411-3(c)(2). Although charitable remainder trusts are not subject to the tax, annuity and unitrust distributions may be net investment income to the non-charitable beneficiary who receives them. The proposed regulations provide detailed rules regarding the calculation of an estate or trust's undistributed net investment income. Prop. Reg. § 1.1411-3(c)(e). Generally, the rules for calculating undistributed net investment income are guided by the subchapter J concept of distributable net income, which apportions income between the trust and its beneficiaries.

- *Net investment income.* Because trade or business income from a passive activity is net investment income, the status of activities as passive and the grouping of activities for purposes of the passive activity loss rules are significant. The proposed regulations provide taxpayers with a fresh start to regroup activities in the first tax year that begins after 12/31/13 in which § 1411 would apply to the taxpayer. Prop. Reg. § 1.469-11(b)(3)(iv). Net investment income, which is investment income reduced by the deductions properly allocable to that income, cannot be less than zero. Deductions that exceed investment income can be carried forward only to the extent provided in chapter 1 of the Code. Prop. Reg. § 1.1411-4(f)(1)(ii). Deductions carried over to a tax year because they were suspended or disallowed by other provisions, such as the investment interest, basis, at-risk or passive activity loss limitations, and allowed for that year in determining adjusted gross income are also allowed in determining net investment income. This is true regardless of whether the taxable year from which the deductions are carried precedes the effective date of § 1411. If items of net investment income (including the properly allocable deductions) pass through to an individual, estate, or trust from a partnership or S corporation, the allocation of the items must be separately stated under § 702 or § 1366. The proposed regulations provide detailed guidance on determining the net investment income arising from the disposition of interests in partnerships or S corporations. Prop. Reg. § 1.1411-7.

- *International issues.* Under § 951(a), United States shareholders who own stock in a controlled foreign corporation on the last day of the corporation's taxable year must include in gross income their pro rata share of the CFC's subpart F income. Similarly, United States persons who hold stock of a passive foreign investment company and elect to treat the PFIC as a qualified electing fund must include in gross income currently under § 1293 a pro rata share of the PFIC's earnings and profits. When the CFC or PFIC later distributes its earnings, the shareholders can exclude the distributions from gross income to the extent they previously were taxed on them. These income inclusions and exclusions result in positive and negative stock basis adjustments. Because these income inclusions are not treated as dividends unless expressly provided for in the Code, the proposed regulations do not treat the income inclusions as net investment income for purposes of § 1411. Instead, CFC shareholders and PFIC shareholders who have made a qualified electing fund election must treat actual distributions of previously taxed earnings as net investment income. Prop. Reg. § 1.1411-10(c)(2)(i). One effect of this rule is that a CFC or PFIC shareholder can have one stock basis for purposes of chapter 1 of the Code and a different stock basis for purposes of the § 1411 tax. To avoid these complexities, the proposed regulations allow a taxpayer to elect to treat the income inclusions required by § 951(a) and § 1293 as net investment income. Prop. Reg. § 1.1411-10(g). The election can be revoked only with the Service's consent. Although the proposed regulations do not address the issue, it appears that the § 1411 tax cannot be reduced with foreign tax credits because foreign tax credits reduce taxes imposed by chapter 1 of the Code, and § 1411 is located in chapter 2A.

- *See also*, FAQs on the net investment income tax, released by the IRS on 11/29/12, 2012 TNT 232-47.

3. "Middle class" tax rates extended "permanently" by the 2012 Taxpayer Relief (and not so grand compromise) Tax Act, but the "rich" must pay more. These changes made by Act §§ 101 and 102 include:

- **Individual income tax rates.** The 10%, 15%, 25%, 28%, 33%, and 35% tax rates enacted in 2001 have been made permanent (including the expansion of the 15% bracket to mitigate the "marriage penalty"). However, the 39.6% rate from pre-2001 Act law has been restored for taxable incomes in excess of the following amounts: (1) $450,000 for married couples filing jointly and surviving spouses; (2) $425,000 for head-of-households; (3) $400,000 for single taxpayers; (4) $225,000 for married taxpayers filing separately. For tax years after 2013, these highest bracket threshold amounts are adjusted for inflation with 2012 as the base year. (For trusts and estates the brackets are 15%, 25%, 28%, 33% and, for income in excess of $11,950, 39.6%; there is no 35% rate bracket.)

- **Capital gains and dividends.** Taxing qualified dividends at the same rate as long-term capital gains has been made permanent, but the maximum rate has been increased. The maximum rates are as follows: 20% for income otherwise in the 39.6% bracket, 15% for income otherwise in the 25% or higher bracket (but below the 39.6%), and zero for income otherwise in the 10% or 15% bracket.

- **The above rates are in addition to the Affordable Care Act investment income tax.** Beginning in 2013, the 3.8% net investment income tax under Code § 1411 applies to taxpayers whose modified adjusted gross income exceeds (1) $250,000 for joint returns and surviving spouses; (2) $125,000 for separate returns, and (3) $200,000 for all other taxpayers. Thus, for qualified dividends and most capital gains, the overall rate for taxpayers in the 39.6% rate bracket will be 23.8%. For taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income is below the 39.6% rate threshold and are subject to the net investment income tax, the rate will be 18.8%.

B. Miscellaneous Income

1. Who ever heard of a local real property tax appraisal that was anywhere near accurate? Shepherd v. Commissioner, T.C. Memo. 2012-212 (7/24/12). The taxpayers compromised a consumer credit card debt for $4,412 less than the balance and claimed that pursuant to § 108(a)(1)(B) none of the COD income should be recognized because they were insolvent. The IRS and taxpayers agreed on the amount of the taxpayers' debts and the value of all of their property with three exceptions: (1) the value of their principal residence, (2) the value of a beach house, and (3) whether a pension was an asset to be included in the determination of insolvency. The Tax Court (Judge Ruwe) held that taxpayers were not able to demonstrate insolvency because they failed to establish the value of the residences. Local tax assessments introduced by the taxpayers were insufficient evidence of value because "a value placed upon property for local taxation purposes is not determinative of fair market value of the property for Federal income tax purposes in the absence of evidence of the method used in arriving at that valuation." Appraisals introduced into evidence were based on "comparable" sales more than two years after the date of discharge, and thus were not probative of the value of the homes at the time of the debt cancellation. The portion of the pension that could have been withdrawn (or borrowed), but not the excess thereover, was included in the value of assets, because "the word 'assets' as used in the definition of the term 'insolvent' for section 108(d)(3) includes 'assets exempt from the claims of creditors under applicable State law'" citing *Carlson v. Commissioner*, 116 T.C. 87, 105 (2001). The taxpayers were not insolvent, and the COD income was includible in income.

2. If you take the Fifth in front of a Senate investigating committee, you may

become a martyr, but if you take the Fifth in front of the Tax Court, you lose. A Cicero, Illinois politician fraudulently underreported income by omitting conversion of $350,000 campaign funds to personal use, but that's small potatoes compared to the more than $10 million insurance fraud scheme for which she spent time in the federal slammer. There may well be a falcon mixed up in here as well, but no sign of it appears in the Tax Court opinion. Loren-Maltese v. Commissioner, T.C. Memo. 2012-214 (7/30/12). The taxpayer, Betty Loren-Maltese, was the President of Cicero, Illinois — "a suburb of Chicago that sits on its western hip like a well-holstered gun, and that has a colorful history that reaches back into the 1920s when Al Capone took refuge there" — and the Republican Committeeman of Cicero Township in 1994. She also served as Cicero's deputy liquor commissioner, a position to which she was appointed by her husband, a "prominent Cicero politician who confessed to being a mob bookmaker and pleaded guilty to a federal gambling charge," when the previous deputy liquor commissioner resigned during an FBI investigation into his practice of taking bribes and skimming money off liquor-license renewal fees. In 2002, Loren-Maltese was convicted of conspiracy to defraud Cicero through a pattern of racketeering via multiple acts of bribery, money laundering, mail and wire fraud, official misconduct, and interstate transportation of stolen property. The conviction ended her political career, and she was sentenced to eight years in prison. The government tried her separately on criminal tax fraud charges, but the trial ended in a hung jury, and the government decided not to try her again. In the instant case, the IRS asserted a deficiency for unreported income and civil fraud penalties based on Loren-Maltese's purchase of a 1993 classic black Cadillac Allante convertible for her personal use and her investment in a luxury golf course and clubhouse with checks totaling more than $350,000 drawn on her "Committeeman Fund" account. (For the year in question, Illinois law allowed public officials, who like Loren-Maltese, were also political-party officials, to raise money from donors in their capacity as party officials, in amounts that they could keep secret. The evidence established that Cicero's town attorney explained to Loren-Maltese that she could supplement her salary by taking money from the Committeeman Fund to buy something for herself or to make an investment for her own personal benefit, but the money would be personal income to her and she would owe tax on it in the year that she took it.) The Tax Court (Judge Holmes) found that both items should have been included in Loren-Maltese's income and that her failure to do so was due to fraud. Importantly, Loren-Maltese was mostly silent during her trial, relying on her attorney's advice to take shelter under the Fifth Amendment. Judge Holmes found that Loren-Maltese's valid invocation of the Fifth Amendment nevertheless allowed the court to draw a negative inference from her refusal to answer question where the IRS produced some additional supporting evidence. Similarly, he drew inferences from Loren-Maltese's silence where, under the circumstances, it would have been natural for her to object.

3. It looks like-the home mortgage crisis continues, so the mortgage COD exclusion continues. The 2012 Taxpayer Relief Act, § 202, extends the exclusion from income of discharged principal residence indebtedness under § 108(a)(1)(E) to indebtedness discharged before 1/1/14.

4. Excludible mass transit and parking fringe benefits are brought to sweet harmony. For 2012 employees were allowed to exclude $240 per month for parking but only $125 for employer-provided mass-transit and vanpool benefits. Congress came to the rescue in the 2012 Taxpayer Relief Act to provide the same benefit (indexed to $245) through 2013. Congress did not explain how the benefit will apply retroactively in 2012. Perhaps the IRS can figure it out.

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

1. Only a doctor could think he could win this case. Verrett v. Commissioner, T.C. Memo. 2012-223 (8/2/12). The taxpayer was a physician who had an annual salary as such of approximately $120,000 in each of the three years at issue. He claimed losses from a construction business run from his home for which he had no license and had never showed a profit in 17 years. Most of his services during the years at issue involved uncompensated projects for his family and his church.

Obviously, the losses were disallowed under § 183.

2. Computing the home office deduction just got easier, but qualifying for it still remains as difficult as ever. Rev. Proc. 2013-13, 2013-6 I.R.B. 478 (1/15/13). This revenue procedure provides an optional safe harbor method that taxpayers may use to determine the amount of expenses deductible under § 280A for business use of a portion of a personal residence, i.e., the "home office deduction," in lieu of calculating, allocating, and substantiating of actual expenses. Taxpayers using the safe harbor method must satisfy all requirements of § 280A for determining eligibility to claim a deduction. Under the revenue procedure, in lieu of depreciation, and allocable repairs, utilities, and insurance, a taxpayer may deduct $5 per square foot for up to 300 square feet (i.e., a maximum of $1,500 per year) for the portion of the residence used *exclusively* for business as required by § 280A. A taxpayer electing the safe harbor method for a taxable year cannot deduct any actual expenses related to the qualified business use of that home, but may deduct all of the qualified home mortgage interest and real estate taxes, as well as any allowable casualty losses, as itemized deductions. (Depreciation for the year is treated as zero.) A taxpayer using the safe harbor method may deduct allowable trade or business expenses unrelated to the qualified business use of the home, such as advertising, wages, and supplies. An election for any taxable year is irrevocable, but the election is year-by-year, and changing from the safe harbor method in one year to actual expenses in a succeeding taxable year, or vice-versa, is not a change of accounting method. The safe harbor method does not apply to an employee with a home office if the employee receives from an employer advances, allowances, or reimbursements for expenses for the business use of the employee's home. There are other details and several examples.

- For one of the gotchas that still remains, see *Hamacher v. Commissioner*, 94 T.C. 348 (1990).

3. What the taxpayer says his tax lawyer said is a "fair" price is not probative evidence. DiDonato v. Commissioner, T.C. Memo. 2013-11 (1/14/13). Among the many issues in this case, virtually all of which went disastrously for the taxpayer, was the applicability of the § 280A limitation on deductions for personal residences used for mixed business and personal purposes. The taxpayer rented a property to his father as the father's principal residence for the entire year in question. Notwithstanding the general rule in § 280A(d) that a family member's use of a dwelling unit is treated as personal by the taxpayer, § 280(d)(3) provides that a taxpayer is not treated as using the property for personal purposes for any period for which the dwelling unit is rented to the family member for use as the family member's principal residence at a fair rent. The Tax Court (Judge Laro) held that the taxpayer failed to prove that the rent was "fair" because the taxpayer "offered no evidence at trial as to the fair rental value of the ... property other than [his own] testimony that the amount of rent to be charged was set by his tax attorney and, in [his own] view, the rent was fair by virtue of his belief that the property was in "deplorable shape." That testimony alone was unpersuasive, because the legislative history makes clear that the fairness component be determined on the basis of comparable rents in the area. See H.R. Rept. No. 97-404, at 8 (1981).

- **See an earlier opinion in this case.** DiDonato v. Commissioner, T.C. Memo. 2011-153 (6/29/11). The Tax Court (Judge Laro) denied a 2004 charitable contribution deduction on grounds of lack of substantiation under § 170(f)(8). The alleged donation was memorialized by a 2004 contract between taxpayer and the charitable recipient but the formal transfer did not occur until 2006, when the donation was acknowledged. The 2006 acknowledgment was too late to substantiate a 2004 deduction because it was received by taxpayer after his 2004 federal income tax return was filed.

D. Deductions and Credits for Personal Expenses

1. Married filing separately status can put a big dent in the home mortgage interest deduction. Bronstein v. Commissioner, 138 T.C. No. 21 (5/17/12). The taxpayer, who was married, purchased a residence as joint tenants with rights of survivorship together with her father-in-law. The taxpayer and her husband resided in the home, and her father-in-law did not. The amount of the mortgage exceeded $1.3 million, and the taxpayer made all of the payments on the mortgage. The taxpayer, who filed separately, deducted interest on $1.1 million of the mortgage. The Tax Court (Judge Goeke) applied § 163(h)(3)(B)(ii), which provides that a married individual filing a separate return is limited to a deduction for interest paid on $500,000 of home acquisition indebtedness, and § 163(h)(3)(C)(ii), which provides that a married individual filing a separate return is limited to a deduction for interest paid on $50,000 of home equity indebtedness, which limits the taxpayer's total deduction to interest on $550,000 of mortgage debt. Section 6662 accuracy-related penalties were upheld, even though the taxpayer claimed to have relied on her tax advisor in taking her return position, because "she . . . made no attempt to establish that the reliance was reasonable."

- Interestingly, the same tax advisor who prepared her return also represented her in the Tax Court litigation.

2. No dependency or child credits for nonresident, noncitizen children. Carlebach v. Commissioner, 139 T.C. No. 1 (7/19/12). This case involved whether the taxpayers were allowed § 151 dependency exemption deductions and § 21 and § 24 child-related credits, which require that the children satisfy the same statutory test, for non-resident, non-citizen children. One of the married taxpayers was a U.S. citizen and the other an Israeli, and they lived in Israel; the children were born in, and lived in Israel. The Tax Court (Judge Halpern) applied § 152(b)(3)(A), which provides that "[t]he term 'dependent' does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States," and Reg. § 1.152-2(a)(1), which provides that "to qualify as a dependent an individual must be a citizen or resident of the United States . . . at some time during the calendar year in which the taxable year of the taxpayer begins" to deny the deductions and credits. He rejected the taxpayers' argument that because the children were citizens in the year (2007) in which returns were filed, they qualified as dependents for the years at issue (2004 through 2006). He also rejected the taxpayers' argument that the children had "derivative citizenship" under 8 U.S.C. § 1433, because such citizenship is not automatic, but requires an application and naturalization, which had not occurred during the years in question. Finally, he rejected the taxpayers argument that because § 152(b)(3)(A) does not require citizenship during the year in question, Reg. § 1.152-2(a)(1), which does require citizenship during the year in question, was invalid. The regulation was a reasonable interpretation of § 152(b)(3)(A), which he interpreted "in the context of subtitle A of the Internal Revenue Code, which deals with income taxes, and in which the concept of an annual accounting system is deeply embedded." Section 6662 accuracy related penalties were upheld.

3. An incomplete effort to collect on a homeowner's insurance policy is all that's necessary to secure a casualty loss deduction. Ambrose v. United States, 106 Fed. Cl. 152 (Fed. Cl. 8/3/12). The taxpayers' home was destroyed in a fire, and the next day they filed a timely claim with their homeowner's insurance company. However, they failed to file a timely "proof of loss" as required by the insurance policy; they sued the insurance company in state court and lost. The IRS applied § 165(h)(5)(E) to deny the taxpayer's claim for a casualty loss deduction. Section 165(h)(5)(E) provides that "[a]ny loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss." The Court of Federal Claims (Judge Allegra) upheld the taxpayers' refund claim, allowing the casualty loss deduction, on the ground that § 165(h)(5)(E) does not apply to a taxpayer who files a timely claim but whose claim is rejected by the insurance company when the taxpayer fails to timely file a "proof of loss" as required by the insurance policy. Reading from Webster's Dictionary to divine the meaning of the terms "file" and "claim" in § 165(h)(5)(E), Judge Alegra concluded that there is a "distinction between the filing of a claim, i.e. the 'deliver[y] . . . to the proper officer' of a 'demand for something due or believed to be due' and the subsequent submission of proof of the validity of that claim," and that in enacting § 165(h)(5)(E), Congress intended to require only the former. He rejected the government's argument that "an insurance 'claim' [includes fulfilling] all of the conditions on recovery found in a given policy."

4. If you don't plead the right theory, you lose – even though had you pled the correct theory, you might have won. Halata v. Commissioner, T.C. Memo. 2012-351 (12/19/12). In 2007, the taxpayer was suckered by her female paramour into paying $180,000 in a scam "bank guarantee transaction" that promised a return of $2.5 million, with the first installment to be received only a few weeks after the payment was made. The "opportunity" was presented through one Montgomery, a California lawyer, who provided the taxpayer with documents memorializing the transaction. No funds ever were received. The taxpayer hired a lawyer to attempt to recover the funds. Montgomery insisted that the purported bank-guaranty transaction was a legitimate transaction, that he was merely a facilitator of the transaction, received no money, and had no information about how the transaction worked or the identities and roles of the parties to the transaction. In 2009, the taxpayer's lawyer advised her that a suit against Montgomery likely would be fruitless. The taxpayer did not claim a theft deduction on her 2007 tax return and did not file a 2008 tax return. The IRS audited her for 2007 and 2008 and proposed deficiencies. In the Tax Court, the taxpayer argued that she suffered a theft loss in 2007 and 2008 that would offset her otherwise unreported income. The Tax Court (Judge Morrison) agreed with the taxpayer that a theft had occurred under the relevant state law and that Montgomery most likely was the thief, but denied a deduction for the year before the court because the loss was not sustained until 2009. Based on all of the facts, prior to 2009, she had a reasonable prospect of recovery. Furthermore, the taxpayer never filed a pleading asserting her theory that there was a net-operating loss for 2009 that should be carried back to prior years. Judge Morrison concluded:

> 3. The effect of the theft-loss deduction for 2009 on Halata's tax liabilities for 2007 and 2008
>
> The next issue to resolve is whether Halata's theft loss in 2009 creates a net-operating loss for 2009 that should be carried back and deducted against her 2007 or 2008 income. The difference between gross income and deductions is a net-operating loss. See sec. 172(c). A net-operating loss for 2009 exists if Halata's deductions for 2009, including the theft-loss deduction, exceed her gross income for 2009. The general rule for carrying back net-operating losses is that a net-operating loss is first deducted from income in the tax year that is two years before the year of the net-operating loss. See sec. 172(b)(1)(A)(i). The year of the net-operating loss that would result from Halata's theft loss is 2009, and, therefore, under the general rule, the first year of the carryback period would be 2007. The year 2007 is before us jurisdictionally. The problem is that Halata never filed a pleading asserting her theory that there was a net-operating loss for 2009 that should be carried back to prior years. See Tax Ct. R. Pract. & Proc. 34(b)(4) (petition is required to "assign[]", i.e., state, every error alleged to have been made by the IRS in the determination of the deficiency). The Court and the IRS were not advised of her theory until after trial. See Tax Ct. R. Pract. & Proc. 31(a) (purpose of pleadings is to give parties and Court fair notice of matters in controversy). Therefore she is barred from asserting it. See Tax Ct. R. Pract. & Proc. 34(b)(4) (any issue not raised in assignments of error in petition is deemed conceded). Also, Halata would have had the burden of proof regarding the net-operating loss. She adduced no evidence regarding her gross income for 2009 and her deductions for 2009 (other than the $ 181,104 theft-loss deduction). Without this information, her net-operating loss cannot be calculated. She would not have met her burden of proof. See Paulson v. Commissioner, T.C. Memo. 1991-508, 62 T.C.M. (CCH) 968, 974 (1991).

- The lawyer who represented the taxpayer in this matter appeared to have been unaware of Rev. Rul. 2009-9, 2009-2 C.B. 735 (the "Madoff" ruling, which discussed the three-year carryback for theft losses under § 172(b)(1)(F)) until after the trial.

5. **One P&S, one loan, one property – all residence.** Norman v. Commissioner, T.C. Memo. 2012-360 (12/27/12). The taxpayers purchased a principal residence on 8.875 acres of land for $1.8 million. The land was zoned for 1/4 acre lots, and the taxpayers hired a civil engineering firm to study the feasibility of development. However, the purchase contract did not allocate the price between the residence with a limited amount of acres and remaining acreage, and the taxpayers obtained a single mortgage of $1,860,000. The land was never subdivided. The taxpayers deducted all of the interest on the mortgage, but the IRS allowed only the interest on $1.1 million as qualified home mortgage interest, rejecting the taxpayer's claim that they paid $1 million was for the dwelling unit plus three acres and $800,000 for "investment property" consisting of the other 6.875 acres. The Tax Court (Judge Thornton) upheld the deficiency, largely on the grounds that the purchase contract did not allocate the price between the residence and the acreage that was purportedly investment property and the acquisition was financed with a single loan, which included not only the purchase price, but also a line of credit for renovations to the house.

6. **Miscellaneous not-so-permanent extensions through 2013. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act extends multiple expiring individual deductions, but only through 2013, so Congress can be sure it has some work to do next year.** These include extenders for:

a. **Teachers.** Section 201 of the Act extends the § 62(a)(D) above-the-line deduction for up to $250 of classroom related expenditures of elementary and secondary school teachers for expenses incurred in taxable years beginning in 2012 and 2013.

- And who says that the Federal government doesn't abundantly support quality education for children?

b. **Mortgage insurance.** Section 204 of the Act extends the Code § 164(b)(5) deduction as qualified residence interest provided for mortgage insurance premiums incurred in connection with acquisition indebtedness for a qualified residence that are paid or accrued before 1/1/14.

c. **State and local taxes: A not-so-permanent extension of the election to deduct state sales taxes.** Section 205 extends the Code § 164(b)(5) election to deduct state and local sales and use taxes in lieu of state and local income taxes to tax years beginning before 1/1/14.

- **Thank you!** Professor Shepard (Texas) and Professor McMahon (Florida) thank Congress and the President for their solicitude on this issue. For Professor Simmons (California), this provision is irrelevant.

7. **Standard deduction marriage penalty relief is now permanent.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act made permanent the provisions in Code § 63 providing a basic standard deduction for a married couple filing a joint return double the basic standard deduction for single individuals. The basic standard deduction for married taxpayers filing separately is the same as the basic standard deduction for single taxpayers.

8. **PEP and PEASE zombie-like arise from the grave.**

a. **PEP.** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act permanently revived the phase-out of personal exemptions for high-income taxpayers for years beginning after 2012. The phase-out kicks in the following AGI levels: (1) $300,000 for joint returns or surviving spouses; (2) $150,000; and for married taxpayers filing separately; (3) $275,000 for heads of household; and (4) $250,000 for single taxpayers. After 2013, the threshold amounts are adjusted for inflation. The amount of the phase-out, as previously, is 2% of the exemption amount for each $2,500 ($1,500 for married taxpayers filing separate returns), or portion thereof, by which AGI exceeds the phase-out threshold.

b. **PEASE** The Act also permanently revived for years beginning after 2012 the limitation on itemized deductions. Like PEP, the phase-out begins at the following AGI levels: (1) $300,000 for joint returns filers or surviving spouses; (2) $150,000; and for married taxpayers filing separately; (3) $275,000 for heads of household; and (4) $250,000 for single taxpayers. After 2013, the threshold amounts are adjusted for inflation. The amount of the phase-out, as previously, is 3% of the excess of certain itemized deductions over the threshold amount, but not by more than 80% of the itemized deductions subject to the limitation. (As previously, the limitation does not apply to medical expenses, investment interest, casualty and theft losses, and wagering losses.)

9. **Making children permanently cheaper.** The Taxpayer Relief (and not so grand compromise) Tax Act extended permanently the increase of the § 24 child credit for taxpayers having children under age 17 to $1,000. (No inflation adjustment has been added.) The refundability of the credit to the extent of 15% of the taxpayer's earned income in excess of $3,000 (unindexed) has been extended only through 2017.

10. **Send the kids to day care, get a tax break.** The Taxpayer Relief (and not so grand compromise) Tax Act extended permanently the increases to the § 21 dependent care credit in the EGTRRA 2001. The credit is 35% of up to $3,000 of eligible expenses (maximum $1,050) for one qualifying dependent, and 35% of up to $6,000 of eligible expenses (maximum $2,100) for two or more qualifying dependents. The 35% credit rate is reduced, but not below 20%, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000.

11. **It's tax-smart to adopt rather than to procreate.** The Taxpayer Relief (and not so grand compromise) Tax Act extended permanently the EGTRRA Code § 23 credit for adoption expenses, but not the changes in the credit in the Patient Protection and Affordable Health Care Act. As a result: (1) the maximum per-child credit is $10,000 (inflation adjusted) for all adoptions; (2) the credit begins to phase-out at a modified AGI of $150,000 (inflation adjusted); (3) for special needs adoptions, the credit is $10,000 regardless of actual expenses; and (4) the credit is allowed against the AMT. The credit remains nonrefundable. For 2013 the maximum credit is expected to be approximately $12,770 and the phase-out is expected to begin at approximately $189,710, after inflation adjustments.

12. **EITC 2001 simplification and expansion is made permanent and 2009 expansion is extended five years.** The Taxpayer Relief (and not so grand compromise) Tax Act made permanent the 2001 simplifying revisions to the Code § 32 earned income tax credit, as amended by the 2003 Jobs and Growth Tax Relief Reconciliation Act and the 2004 Working Families Tax Relief Act, and also extended the 2009 increases in the earned income credit for taxpayers with three or more qualifying children through 2017. Through 2017, the phase-out threshold for married taxpayers filing joint returns will be $5,000 (inflation adjusted) higher than for other taxpayers, and starting in 2018 the phase-out threshold for married taxpayers filing joint returns will be $5,000 (inflation adjusted) higher than for other taxpayers.

13. **Home mortgage interest is deductible only if you actually pay it.** Smoker v. Commissioner, T.C. Memo. 2013-56 (2/21/13). For the years in question, the taxpayer paid over $40,000 of home mortgage interest and approximately $28,000 of home mortgage interest was deferred and capitalized into the principal amount. Although the statutory language of § 163(h)(3) allows a deduction for qualified residence interest that is "paid or accrued" during the taxable year, the Tax Court (Judge Laro) upheld the denial of a deduction for the accrued but unpaid interest, because the taxpayer was an individual on the cash method — which is the method applicable to all individuals with respect to personal expenses. Under well-established precedents, a cash method taxpayer may deduct in any taxable year only interest actually paid during that taxable year. The accrued but unpaid qualified residence interest would not be deductible until actually paid.

14. Is this a casualty loss in limbo? Alphonso v. Commissioner, 136 T.C. 247 (3/16/11). The taxpayer owned stock in a N.Y. cooperative housing corporation from which she rented an apartment as her personal residence. When a retaining wall on the grounds of the apartment complex collapsed, the corporation levied an assessment for the cost of repairs, and the taxpayer paid $26,390, with respect to which she claimed a casualty loss deduction of $23,188 (reflecting computational limitations in § 163(h)). The IRS disallowed the deduction, and the Tax Court (Judge Chiechi) upheld the disallowance. Judge Chiechi reasoned that under the relevant state law and controlling legal instruments, the taxpayer had no property interest in the retaining wall, which was part of the common grounds — nothing in the lease, the corporation charter and by-laws, or any other governing documents indicated that the taxpayer possessed a leasehold interest, an easement, or any other property interest in the common grounds. Finally, Judge Chiechi rejected the taxpayer's argument that § 216, which allows cooperative apartment owners to deduct their shares of the real estate taxes and mortgage interest paid by the cooperative corporation, should be extended by judicial interpretation to casualty losses. Although Judge Chiechi rejected the IRS's argument that the absence of a reference to casualty losses in § 216 conclusively determined that it did not apply to casualty losses, after examining the legislative history she concluded that Congress intended § 216 to apply only to interest and real estate taxes.

a. No, it's not in limbo; the loss is allowed by the Second Circuit. Alphonso v. Commissioner 111 A.F.T.R.2d 756 (2d Cir 2/6/13), *rev'g* 136 T.C. 247 (2011). The Second Circuit, in an opinion by Judge Kearse, reversed the Tax Court's decision. The Court of Appeals concluded that the right of a stockholder in a cooperative housing corporation to use the grounds and to exclude persons who are not tenants or the guests of tenants, coupled with obligations as a tenant stockholder under the cooperative lease, constituted a property interest in the land sufficient to entitle the taxpayer to the claimed casualty loss deduction.

E. Divorce Tax Issues

1. The test for whether it's "alimony" is objective, not subjective. Rood v. Commissioner, T.C. Memo. 2012-122 (4/25/12). The taxpayer was obligated under Florida law to pay his former spouse a "lump sum alimony" award of $300,000 payable over 60 months in $5,000 payments. The Tax Court (Judge Goeke) held that the payments were not deductible as "alimony" because under Florida law the taxpayer's obligation did not terminate upon his former wife's death. The court declined to consider extrinsic evidence in determining the nature of the payments: "The intent of the parties is irrelevant in determining whether such an obligation would terminate at death." Even though the purpose of the requirement of § 71(b)(1)(D) that the payment terminate upon death is to prevent deductions of amounts that are attributable to support of the payee, the relevant inquiry is entirely objective; the intent of the parties regarding the purpose of the payments is irrelevant.

2. A QDRO can't lend tax-free disability payment status to a substitute payee. Fernandez v. Commissioner, 138 T.C. No. 20 (5/14/12). The Tax Court (Judge Wherry) held that § 104(a)(1) does not apply to exclude disability payments paid to the disabled worker's former spouse pursuant to a § 414(p) qualified domestic relations order (QDRO).

> Section 402(a) provides that amounts distributed from employee trusts are taxable to the distributee "Except as otherwise provided in this section", and section 72 provides that "Except as otherwise provided in this chapter gross income includes any amount

received as an annuity *** under an *** endowment, or life insurance contract." Nowhere in section 402(a) or section 72 is section 104(a) mentioned. Section 402(e)(1)(A) explicitly provides: "For purposes of subsection (a) [of section 402] and section 72, an alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order ". If Congress had included section 104 in this portion of the statute, the result in this case might be different. However, without congressional approval we decline to expand the reach of section 402(e)(1)(A) beyond the sections specifically referred to in its text.

3. Counting to six distinguishes child support from alimony. Schilling v. Commissioner, T.C. Memo. 2012-256 (9/5/12). The Tax Court (Judge Swift) applied § 71(c) and Temp. Reg. § 1.71-1T(c), Q&A 18, to hold that the amount by which payments received pursuant to a divorce decree were reduced on dates that corresponded to taxpayer's children attaining age 18 or starting college were child support. However, an amount by which payments were reduced to zero on a fourth date, in the sixth post-separation year was treated as alimony. Although the complete termination of payments occurred within six months of one child's twenty-first birthday, which ordinarily would be treated as related to a contingency relating to a child under § 71(c)(2)(B), Temp. Reg. § 1.71-1T(c), Q&A 18, expressly provides that complete cessation of support payments during the sixth post-separation year does not qualify as a contingency relating to a child.

4. The validity and effect of an admittedly executed Form 8332 is beyond question. George v. Commissioner, 139 T.C. No. 19 (12/19/12). The taxpayer, who was the custodial spouse following a divorce, in compliance with a state court order, executed a Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents), which stated that "I agree not to claim an exemption for" her daughter as a dependent for the years at issue. However, the taxpayer believed that the state court order was improper, because she thought that court lacked jurisdiction to issue such an order and because any such order should have taken into account her former husband's past arrears in child support before enabling him to obtain the dependency exemption. As a result, she nevertheless claimed a dependency exemption and a child tax credit for the child. The taxpayer's former spouse also claimed the child as a dependent for those years and attached the executed Form 8332 to his tax returns. The Tax Court (Judge Gustafson), held that the taxpayer was not entitled to the dependency exemption. The executed Form 8332 was not rendered invalid by any error in the state court order requiring it or by the fact that the taxpayer signed the Form 8332 under the compulsion of that state court order. The release of the claim to the exemption was valid. Likewise the child credit was disallowed.

5. If an ex-spouse disobeys a court order to sign Form 8332, the noncustodial spouse still loses. What's a guy gotta do? Armstrong v. Commissioner, 139 T.C. No. 18 (12/19/12). The taxpayer and his wife divorced, and his ex-wife had custody of their son. A state court order provided that the taxpayer would be entitled to the dependency exemption and explicitly required his ex-wife to execute in his favor a Form 8332, "Release of Claim to Exemption for Child of Divorced or Separated Parents") provided that the taxpayer met child support obligations. The taxpayer met his child support obligations, but his ex-wife failed to provide the executed Form 8332. The IRS disallowed the taxpayer's claimed dependency exemption, even though he appended to his tax return the court order and provided the IRS evidence that he had met his support obligations. In a reviewed opinion (12-3) by Judge Gustafson, the Tax Court upheld the denial of the exemption. The state court order, even though countersigned by the taxpayer's ex-wife was not a substitute for a Form 8332 because it failed to unconditionally declare that the ex-wife "will not claim such child as a dependent" for the year at issue. That defect is not cured by the noncustodial parent's proof that he has fulfilled support conditions beyond those in the statute. Likewise the child credit was disallowed.

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

6. Here's how to shift taxation of child support payments to the custodial spouse if state law allows it. DeLong v. Commissioner, T.C. Memo. 2013-70 (3/11/13). The Tax Court (Judge Kroupa) held that an unallocated family support allowance that under California law was intended to provide both spousal and child support that terminated entirely upon the death of the custodial payee spouse, but was not by its terms reduced upon emancipation of the children, was entirely alimony.

F. Education

1. Congress encourages universities to raise tuition even more in the next five years. The Taxpayer Relief (and not so grand compromise) Tax Act extended the 2009 expansion of the Code § 25A American Opportunity Tax Credit (formerly known as the Hope Scholarship credit) through 2017.

a. Doubling down on encouraging universities to raise tuition even more in the next five years. Section 207 of the Taxpayer Relief (and not so grand compromise) Tax Act reinstates and extends the above-the-line deduction of higher education expenses provided in Code § 222(d) for expenses incurred in taxable years 2012 and 2013. Previously § 222(d) applied only to expenses incurred before 12/31/11.

2. Helping banks keep student loan interest rates higher. The 2012 Tax Act made permanent the EGTRRA changes to the Code § 221 above-the-line deduction for qualified higher education student loan interest.

3. Helping banks market education IRAs. The 2012 Tax Act made permanent the many EGTRRA changes to the Coverdell education savings account ("Coverdell ESA," or "CESA," formerly called an "education IRA") rules (§§ 25A, 530). The 2001 changes that have been extended permanently are extensive and since they have been in place for twelve years, we won't bore you with them.

4. Encouraging employers to pay for employee's education. The 2012 Tax Act made permanent the Code § 127 tax-free fringe benefit for up to $5,250 annually for amounts paid or expenses incurred by the employer in providing educational assistance to employees under an educational assistance program (including graduate courses).

G. Alternative Minimum Tax

1. Finally — permanent AMT relief!!! The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 104, has provided permanent AMT relief. Beginning in 2012, the AMT exemption amount has been increased to: (1) $78,750 for married couples filing jointly and surviving spouses; (2) $39,375 for married individuals filing separate returns; and (3) $50,600 for single taxpayers. These amounts are subject to automatic adjustment for inflation after 2012 using 2011 as the base year. The AMT exemption is phased out by an amount equal to 25% of the amount by which AMT exceeds the following thresholds: (1) $150,000 for married couples filing jointly and surviving spouses; (2) $75,000 for married individuals filing separate returns; and (3) $112,500 for single taxpayers. The phase-out thresholds are likewise subject to inflation adjustments. (The 2012 Act did not change the $22,500 exemption amount for estates and trusts.) The 2012 Act also provides permanent 0%, 15%, and 20% (for taxpayers otherwise in the 39.6% bracket for ordinary income) AMT rates for long-term capital gains and qualified dividends. The rule under Code § 26(a)(2) allowing various nonrefundable personal credits to offset AMT has been made permanent. Finally, by an amendment to Code § 26, the § 24 refundable child credit offset of AMT has been made permanent.

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. **The cat's out of the bag!** DKD Enterprises, Inc. v. Commissioner, 685 F.3d 730 (8th Cir. 7/17/12), *aff'g* T.C. Memo. 2011-29 (1/31/11). The Eighth Circuit, in an opinion by Judge Riley, held that expenses incurred by a corporation to operate a cattery, the deductions for which were disallowed because the cattery was not operated with a genuine profit-seeking motive, constituted constructive dividends to the corporation's sole shareholder because the corporation operated the cattery "for the personal pleasure of . . . its sole stockholder, and that during each of those years that activity was incident to [her] personal hobby." Because the corporation did not have "a legitimate business purpose to operate the cattery," the expenditures to operate constituted a constructive dividend "even though this activity conferred no tangible economic benefit on [the shareholder."

2. **Is section 306 like the human appendix — a vestige of something that might have once served a purpose?** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act made permanent the treatment as qualified dividend income of ordinary income realized under Code § 306. The only effect of § 306 now is to affect basis recovery.

C. Liquidations

1. **Adios collapsible corporations. But how will tax professors be able to torture their students now?** The 2012 Taxpayer Relief (and not so grand compromise) Tax Act permanently repealed the infamous Code § 341.

D. S Corporations

1. **An S corporation is not an individual, even if an IRS employee said so.** Trugman v. Commissioner, 138 T.C. No. 22 (5/21/12). The taxpayers moved from California to Nevada to avoid state income taxes. They acquired a principal residence in Henderson, Nevada through their wholly owned S corporation, which held rental properties in Missouri, Texas, and California. The taxpayers claimed the $8,000 first time homebuyer's credit under now-expired § 36, which was available to an "individual" who had no present ownership interest in a principal residence during the three year period ending on the date of the purchase. The Tax Court (Judge Kroupa), in a case of first impression, held that a corporation is not an individual for purposes of § 36, and election of subchapter S status does not change that characterization. The pass-through nature of the credit did not alter the fact that the corporation purchased the property. The court pointed out that individuals can have a principal residence, but a corporation has a principal place of business. The court also was unsympathetic to the taxpayer's request for leniency on the grounds that an IRS representative advised them that they could claim the credit if the residence was purchased through an S corporation. The court pointed out that the Commissioner is not bound by the erroneous legal advice of IRS employees.

- Even though an S corporation is taxed like an individual (with four enumerated exceptions) under § 1363(b), an S corporation is still not an individual.

2. **Paper is substance. Corporate resolutions and ledger entries create an "economic outlay." — No kidding, they really do, says Judge Ruwe.** Maguire v. Commissioner, T.C. Memo. 2012-160 (6/6/12). The taxpayers in these consolidated cases owned two S corporations with

related businesses – one was an auto dealership, and the other a finance company that purchased customer notes from the auto dealership. The finance company operated at a profit and the dealership operated at a loss. Apart from the transactions at issue, the taxpayers did not have sufficient basis in the dealership to deduct losses, but had substantial basis in the finance company. The finance company owned substantial accounts receivable due from the dealership. At the end of each year, through journal entries, the finance company distributed accounts receivable to the taxpayers, who in turn contributed them to the related dealership to increase the basis in the dealership sufficiently to avoid the § 1366(d) limitation on the deduction of passed through losses. The IRS disallowed the claimed loss deductions on the grounds that the transactions did not increase the taxpayers' basis in the dealership because the taxpayers had not made an "an economic outlay." The IRS argued that the corporate "resolutions and adjusting journal entries made to the books of the related companies were devoid of any economic reality and did not alter the economic positions of the parties." The Tax Court (Judge Ruwe) rejected the IRS's position and held for the taxpayer, finding that the "distributions and contributions did have real consequences that altered the positions of petitioners individually and those of their businesses." Thus, the transactions did result in the taxpayer making the required "economic outlay."

> [T]he distributions and contributions created actual economic consequences for the parties, because the accounts receivable had real value in that they were legitimate debts that Auto Acceptance owed to CNAC and thus were legitimate assets of CNAC. Petitioners' contribution of the accounts receivable resulted in their being poorer in a material sense in that the accounts receivable were no longer collectible by them individually.

- Judge Ruwe added that he saw "no reason why shareholders in two related S corporations should be prohibited from taking distributions of assets from one of their S corporations and investing those assets into another of their S corporations, in order to increase their bases in the latter. The effect is to decrease the shareholders' bases in the S corporation making the distribution, thereby reducing the shareholders' potential future tax-free distributions from the distributing S corporation, while increasing the shareholders' bases in the S corporation to which the contribution is made." Furthermore, "[t]he fact that the two S corporations have a synergistic business relationship and are owned by the same shareholders should make no difference so long as the underlying distributions and contributions actually occurred."

- But for the fact that the shareholders' ownership of the two corporations was not congruent, this issue could have been avoided by having the two operating corporations organized as subsidiary QSubs of an S corporation holding company.

3. The Treasury Department proposes major surgery on the rules for determining an S corporation shareholder's basis limitation for passed-through losses under § 1366(d). REG-134042-07, Basis of Indebtedness of S Corporations to Their Shareholders, 77 F.R. 34884 (6/12/12). The Treasury Department has proposed amendments to Reg. § 1.1366-2 that would deal with determination of an S corporation shareholder's basis in any debt of the S corporation, which principally affects the limitation on the pass-through of losses under § 1366(d). The proposed regulations expressly provide that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg. § 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Prop. Reg. § 1.1366-2(a)(2)(i). Furthermore, the proposed regulations expressly provide that:

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

- The preamble states that "[u]nder these proposed regulations, an incorporated pocketbook transaction [see, e.g., *Yates v. Commissioner*, T.C. Memo. 2001-280; *Culnen v. Commissioner*, T.C. Memo. 2000-139] increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation."

- Prop. Reg. § 1.1366-2(a)(2)(ii), Example (3) in the proposed regulation blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation "constitutes bona fide indebtedness" from the borrower S corporation to the shareholder. Example (4) in the proposed regulation blesses a basis increase resulting from a distribution of a note from one S corporation (S2) to another S corporation (S1) if after the distribution S2 is indebted to the shareholder and "the note constitutes bona fide indebtedness" from S2 to the shareholder.

- The proposed regulations do not attempt to clarify the meaning of "bona fide indebtedness," or provide any examples of relevant facts and circumstances, but rely on "general Federal tax principles." This may portend that the voluminous debt versus equity jurisprudence might replace the "actual economic outlay" by the shareholder test for creating basis of indebtedness, applied in cases such as *Maloof v. Commissioner*, 456 F.3d 645 (6th Cir. 2006); *Spencer v. Commissioner*, 110 T.C. 62, 78-79 (1998), *aff'd without published opinion*, 194 F.3d 1324 (11th Cir. 1999); *Hitchins v. Commissioner*, 103 T.C. 711 (1994); and *Perry v. Commissioner*, 54 T.C. 1293 (1970). The preamble refers to *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998); *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); and *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973), as relevant authorities.

- The proposed regulations do not address how to determine the basis of the shareholder's stock in the S corporation. Rev. Rul. 81-187, 1981-2 C.B. 167, provides that a shareholder of an S corporation does not increase basis in stock for purposes of § 1366(d)(1)(A) by contributing the shareholder's own unsecured demand promissory note to the corporation. In the preamble, the Treasury Department and the IRS have requested comments concerning the propriety of basis calculations in the S corporation and partnership context, similar to the one currently in Reg. § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note.

- The proposed regulations will apply to loan transactions entered into on or after the date of publication of final regulations.

4. Shareholder consent to an S election constitutes consideration paid to the S corporation for cash distributions. — Say What! In re Kenrob Information Technology Solutions, Inc., 110 A.F.T.R.2d 2012-5190 (Bankr. E.D. Va. 7/10/12). Kenrob was an S corporation in bankruptcy. Pursuant to a long-standing pre-existing agreement between the corporation and the shareholders, the corporation had paid directly to the IRS the personal income taxes attributable to the shareholders' passed-through income. The trustee asserted that the payments were fraudulent conveyance because they were made without consideration by the corporation. The Bankruptcy court rejected the trustee's argument, holding that the consideration received by the corporation was the shareholders' "election" — the court should have said "consent" to have the corporation be taxed as an S corporation — as long as the corporation paid the resulting personal income tax liability. The benefit to the corporation was the § 11 taxes that it would not have had to pay had it not made the S election.

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

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

6. S corporation charitable contributions favored with reduced basis deductions. The 2012 Taxpayer Relief Act, § 325, extended Code § 1367(a)(2), enacted in 2006, which provides that shareholders of an S corporation reduce stock basis by the adjusted basis of property contributed to a charity, even though the full fair market value of the contributed property is passed through to the shareholder as a charitable contribution. Prior law applied to contributions made in tax years beginning before 1/1/12. The two-year extension applies to contributions made in tax years beginning before 1/1/14.

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

E. Mergers, Acquisitions and Reorganizations

1. This District Court decision, if followed, makes it much much more difficult ever to have personal goodwill as an employee-shareholder. Howard v. United States, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 7/30/10). The taxpayer was a dentist who practiced through a solely owned (before taking into account community property law) professional corporation until the practice was sold to a third party. He had an employment agreement with the corporation including a noncompetition clause that survived for three years after the termination of his stock ownership. The purchase and sale agreement allocated $47,100 to the corporation's assets, $549,900 for the taxpayer-shareholder's personal goodwill, and $16,000 in consideration of his covenant not to compete with the purchaser. The corporation did not "dissolve" until the end of the year following the sale. The taxpayer reported $320,358 as long-term capital gain income resulting from the sale of goodwill (the opinion does not explain how the remainder of the sales price was reported, but the IRS recharacterized the goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the third party as a dividend from the taxpayer's professional service corporation. Because the sale occurred

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in 2002, when dividends were taxed at higher rate than capital gains, a deficiency resulted. The government's position was based on three main reasons: (1) the goodwill was a corporate asset because the taxpayer was a corporate employee with a covenant not to compete for three years after he no longer owned any stock; (2) the corporation earned the income, and correspondingly earned the goodwill; and (3) attributing the goodwill to the taxpayer-shareholder did not comport with the economic reality of his relationship with the corporation. After reviewing the principles of *Norwalk v. Commissioner*, T.C. Memo. 1998-279, and *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), the court held that because the taxpayer was the corporation's employee with a covenant not to compete with it, any goodwill generated during that time period was the corporation's goodwill. The court also rested its holding that the goodwill was a corporate asset on its conclusions that the income associated with the practice was earned by the corporation and the covenant not to compete, which extended for three years after the taxpayer no longer owned stock in the corporation rendered any personal goodwill "likely [of] little value."

- See *Solomon v. Commissioner*, T.C. Memo. 2008-102, for an extended discussion of the issues underlying an attempted sale of individual goodwill.

a. Affirmed – "Dr. Howard has offered no compelling reason why he should be let out of the corporate structure he chose for his dental practice." 108 A.F.T.R.2d 2011-5993 (9th Cir. 8/29/11) (nonprecedential opinion). The Ninth Circuit affirmed the district court in an opinion that contains an elegantly concise summary of the current state of the law.

> Goodwill "is the sum total of those imponderable qualities which attract the custom of a business, or which brings patronage to the business." *Grace Brothers v. Comm'r*, 173 F.2d 170, 175-76 (9th Cir. 1949). For purposes of federal income taxation, the goodwill of a professional practice may attach to both the professional as well as the practice. *See, e.g., Schilbach v. Comm'r*, 62 T.C.M. (CCH) 1201 (1991). Where the success of the venture depends entirely upon the personal relationships of the practitioner, the practice does not generally accumulate goodwill. *See Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 at 207–08 (1998). The professional may, however, transfer his or her goodwill to the practice by entering into an employment contract or covenant not to compete with the business. *See, e.g., Norwalk v. Comm'r*, 76 T.C.M. (CCH) 208, *7 (1998) (finding that there is no corporate goodwill where "the business of a corporation is dependent upon its key employees, *unless* they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation") (emphasis added); *Martin Ice Cream Co.*, 110 T.C. at 207-08 (finding that "personal relationships ... are not corporate assets when the employee has *no* employment contract [or covenant not to compete] with the corporation") (emphasis added); *Macdonald v. Comm'r*, 3 T.C. 720, 727 (1944) (finding "no authority which holds that an individual's personal ability is part of the assets of a corporation ... where ... the corporation does *not* have a right by contract or otherwise to the future services of that individual") (emphasis added). In determining whether goodwill has been transferred to a professional practice, we are especially mindful that "each case depends upon particular facts. And in arriving at a particular conclusion ... we ... take into consideration all the circumstances ... [of] the case and draw from them such legitimate inferences as the occasion warrants." *Grace Brothers v. Comm'r*, 173 F.2d 170, 176 (9th Cir. 1949).

- Looking at the facts as found by the District Court, the Ninth Circuit concluded that "while the relationships that Dr. Howard developed with his patients may be accurately described as personal, the economic value of those relationships did not belong to him, because he had conveyed control of them to the Howard Corporation." Furthermore, the court rejected the taxpayer's argument that the purchase and sale agreement impliedly terminated both the employment contract and the non-competition agreement, thereby transferring the accumulated goodwill of the practice back to Dr. Howard; the court added that even if it accepted that argument, "such a release would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice."

b. Has Judge Holmes breathed new vitality into *Martin Ice Cream*? H&M, Inc. v. Commissioner, T.C. Memo. 2012-290 (10/15/12). H&M, Inc. conducted a small town insurance agency business for many years. In the years before it sold its business it paid Schmeets, its principal employee/sole shareholder, an annual salary of approximately $29,000. In an integrated transaction, a bank bought H&M, Inc.'s insurance business for $20,000 and entered into an employment agreement with Schmeets pursuant to which he was paid total compensation of over $600,000 over a six-year period for continuing to run the insurance business on behalf of the bank that purchased the insurance agency. Schmeets kept H&M, Inc. alive and converted its business to (unsuccessfully) exploiting patents developed by its sole shareholder. The IRS asserted a deficiency against H&M, Inc. based on the "substance over form" theory that a significant portion of the compensation paid to Schmeets by the bank under the employment agreement actually was a payment to H&M, Inc. for the sale of the insurance business, and that H&M, Inc. thus realized significant capital gains and interest income over the period the compensation was paid to Schmeets. The IRS's argued that all of the compensation that was fixed in amount actually was part of the purchase price and that only the portion of the compensation that varied (the greater of $50,000 or 45% of "net adjusted income" for the year) was actually compensation. The Tax Court (Judge Holmes) rejected the IRS's argument completely. Applying *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), and *MacDonald v. Commissioner*, 3 T.C. 720 (1944), Judge Holmes concluded that payments by a purchaser of a corporate business to a controlling shareholder for that shareholder's customer relationships were not taxable to the corporation "where the business of a corporation depends on the personal relationships of a key individual [i.e., the controlling shareholder], unless he transfers his goodwill to the corporation by entering into a covenant not to compete or other agreement so that his relationships become property of the corporation." Judge Holmes found the instant case to be like *MacDonald* and *Martin Ice Cream Co.* The insurance business was "'extremely personal,' and the development of [the] business before the sale was due to Schmeets's ability to form relationships with customers and keep big insurance companies interested in a small insurance market." Furthermore, the compensation paid to Schmeets was reasonable, and there were no other intangibles to be accounted for in the purchase price.

- The IRS won on a whole raft of run-of-the-mill other issues, typically found in closely held corporations, none of which are particularly interesting.

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

1. The ELA was triggered in a closed year. LPCiminelli Interests, Inc. v. United States, 110 A.F.T.R.2d 2012-6631 (W.D. N.Y. 11/13/12). The IRS asserted a deficiency against the taxpayer's consolidated group on the grounds that an inactive subsidiary realized COD income in 2004. The taxpayer paid the deficiency and sought a refund. In the refund proceedings, the government conceded that COD issue but asserted that pursuant to Reg. § 1.1504-19, the taxpayer recognized gain from the subsidiary's excess loss account (ELA) upon the worthlessness of the subsidiary's stock in 2004. The taxpayer proved that between 1999 and the end of 2003, the subsidiary's assets declined from more than $8.2 million to $4,128, and that under the pre-2008 version of Reg. § 1.1504-19, the subsidiary's stock was worthless by the end of 2003 — a year beyond the statute of limitations — because the subsidiary had disposed of substantially all of its assets. Accordingly, the court held that the income was not realized in 2004. The government further asserted that even if the subsidiary had disposed of substantially all of its assets prior to 2004, the ELA was properly included in 2004 under the "anti-avoidance rule" of Reg. § 1.1502-19(e), which provides: "If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section." The government's theory was based on the argument that the taxpayer "acted with the purpose of avoiding the regulations by not reporting [the subsidiary] as an inactive subsidiary prior filing its consolidated return for tax year 2004, and by failing to file an amended return for the year (or years) during which the income from [the subsidiary's] ELA was actually realized." The court rejected this argument for two reasons. First, the taxpayer had fully disclosed the facts to the IRS during the audit and had offered to extend the statute of limitations for 2001-2003 on the issue, and while the limitations periods from 2001–2003 were open, the IRS examined the matter and chose not to assess tax based on any realized ELA income. Second, there is no obligation to file an amended return.

H. Miscellaneous Corporate Issues

1. Have you thought about the personal holding company or accumulated earnings taxes recently? Bet not! The 2012 Taxpayer Relief (and not so grand compromise) Tax Act permanently increased from 15% and set at 20% the § 531 accumulated earnings tax and the § 541 personal holding company tax.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. Frack the corporate tax for this waste removal partnership. Ltr. Rul. 201227002 (3/1/12, *released* 7/6/12). The IRS concluded in this private letter ruling that income from the removal, treatment, recycling and disposal of waste products from fracturing processes in oil and gas production is qualifying gross income under § 7704(d)(1)(E), permitting a publicly traded partnership to avoid being taxed as an association under § 7704.

2. Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2, but it was too late to keep the Miss America Pageant in Atlantic City. Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events, and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to nineteen large corporations, which described the transaction as a "sale" of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about $57 million to Historic Boardwalk Hall. and Pitney Bowes made capital contributions of more than $18 million to that LLC, as well as an investor loan of about $1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a "development fee" and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

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

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

a. "'[T]he sharp eyes of the law' require more from parties than just putting on the 'habiliments of a partnership whenever it advantages them to be treated as partners underneath.' ... Indeed, *Culbertson* requires that a partner '*really and truly intend*[] to ... shar[e] in the profits and losses' of the enterprise. ... And, after looking to the substance of the interests at play in this case, we conclude that, because Pitney Bowes lacked a meaningful stake in either the success or failure of Historic Boardwalk Hall, it was not a bona fide partner." Historic Boardwalk Hall LLC v. Commissioner, 694 F.3d 425 (3d Cir. 8/27/12) In a unanimous opinion by Judge Jordan, the Third Circuit reversed the Tax Court and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall LLC. The court's reasoning was based on the *Culbertson* test [*Commissioner v. Culbertson*, 337 U.S. 733 (1949)], as applied by the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (*Castle Harbour II*), to find that the Dutch banks were not partners, and the reasoning of the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), to find that the investors who acquired the Virginia Historic Rehabilitation credits through the partnership bore no "true entrepreneurial risk," which the Third Circuit concluded was a characteristic of a true partner under the *Culbertson* test. The Third Circuit concluded that Pitney Bowes was not a partner because, based on an analysis of the facts, as the transaction was structured, (1) Pitney Bowes "had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought — the HRTCs or their cash equivalent," and (2) Pitney Bowes's "avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential." The analysis was highly factual and based on substance over form. As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court's finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3% preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund,* the Third Circuit treated the 3% preferred return as a "return on investment" that was not a "share in partnership profits," which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that "although in form PB had the potential to receive the fair market value of its interest . . . in reality, PB could never expect to share in any upside." The court noted that it was mindful "of Congress's goal of encouraging rehabilitation of historic buildings," and that its holding might "jeopardize the viability of future historic rehabilitation projects," but the court observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

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

b. The IRS is gilding the lily of its *Historic Boardwalk* victory. FAA 20124002F, 2013 TNT 41-18 (dated 8/30/12; released 10/5/12). This Field Attorney Advice dealt with whether a taxpayer was a partner in a partnership that generated § 47 historic rehabilitation tax credits. The FAA held that under the *Culbertson* as applied in *Castle Harbour*, the taxpayer was not a partner. The taxpayer had no meaningful downside risk in that it is assured of receiving the benefit of its bargain, and it had no upside potential. All it could receive was it specified priority return. Alternatively, the purported partnership was a sham; it served no business purpose. Its only purpose was to effect a sale of the rehabilitation tax credits to the taxpayer. *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), which held that a sale-leaseback transaction involving solar energy equipment had economic substance even though the investment had a negative rate of return before taking into account tax benefits, was distinguished on the ground that the transaction at issue in *Sacks* otherwise had economic substance in terms of risk and reward. In reaching the conclusion, the FAA states as follows:

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

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

3. Deathbed estate planning with intended contributions creates a Texas style family limited partnership. Keller v. United States, 637 F.3d 238 (5th Cir. 9/25/12). On May 10 the decedent met in her hospital bed with advisors to structure estate planning AB trusts as partners with an LLC in a family limited partnership. The decedent executed partnership agreements and indicated that she intended to fund the partnership with community property bonds. The decedent also wrote a check to the partnership which was never cashed. The decedent died on May 15. After attending a CLE conference, the taxpayer's advisors re-thought the estate's estate tax payment and claimed a $147 million refund of estate taxes on the basis of a valuation discount attributable to the assets in the family limited partnership. The IRS asserted that the partnership was never funded. The court, affirming findings by the District Court, held that under "[w]ell-established principles of Texas law" the decedent's intent to make an asset partnership property caused the bonds to be equitably owned by the partnership. Thus the estate was entitled to the valuation discount for the partnership property.

4. Final regulations cover noncompensatory options on partnership interests. T.D. 9612, Noncompensatory Partnership Options, 78 F.R. 7997 (2/5/13). Final regulations under § 721 generally provide for nonrecognition of gain or loss to the partnership or option holder on the exercise of a noncompensatory stock option that grants the holder the right to acquire an interest in the issuer (defined as an option not issued in connection with the performance of services) on the transfer of money or property to the partnership. The regulations also address the maintenance of partnership capital accounts and the determination of partners' distributive shares. As a brief and horribly incomplete summary of the lengthy regulation–

- The regulations provide that § 721 does not apply to the transfer of property in exchange for an option or the satisfaction of a partnership obligation by issuance of an option. The transfer or satisfaction will result in recognition of gain or loss to the option recipient and open transaction treatment with respect to the partnership. The regulations do provide for § 721 treatment for the receipt of convertible equity in exchange for property.

- Section 721 does not apply to the issuance of an option for accrued but unpaid interest, interest on convertible debt, rent, or royalties.

- The nonrecognition rule of § 721 does not apply to the exercise of a noncompensatory option issued by a disregarded entity what would become a partnership if the option were exercised.

- The investment partnership rules of § 721(b) apply to cause recognition if the partnership would be treated as an investment company.

- Cash settlement of a noncompensatory option is treated as a sale or exchange of the option under § 1234 rather than as a contribution to a partnership.

- Lapse of a noncompensatory option is treated as recognition of gain to the partnership and a loss to the option holder to the extent of the option premium. For this purpose, proposed regulations under § 1234 would treat partnership interests as securities for purposes of § 1234 (REG-106918-08, Treatment of Grantor of an Option on a Partnership Interest, 78 F.R. 8060 (2/5/13)).

- Redemption of an interest following exercise of a noncompensatory option may be treated as a disguised sale. In addition, general tax principles will apply to determine the nature of the transaction if the exercise price of a noncompensatory option exceeds the capital account received by the option holder.

- The regulations permit revaluation of partnership capital accounts on issuance of a noncompensatory option and provide further that any revaluation of partnership capital accounts must take into account the fair market value of any outstanding noncompensatory options. The value of partnership property must be adjusted to reflect the difference (if any) between the value of outstanding noncompensatory options and the amount paid by the option holder as consideration for the option.

- The regulations require corrective allocations to account for any shift in partner's capital accounts that results from capital account reallocations pursuant to exercise of a noncompensatory option. Corrective allocations to the option holder can only include items properly allocable to a partner who suffered a capital account reduction.

- Noncompensatory options are generally not characterized as partnership equity. However, an option holder will be treated as a partner if the option holder's rights are "substantially similar" to rights afforded to a partner, and there is a strong likihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate Federal tax liabilities under the facts and circumstances. The relevant facts and circumstances include the likelihood that the option would be exercised. The regulations contain a couple of safe harbors indicating that an option is not reasonably expected to be recognized (exercisable more than 24 months after the measurement date with a strike price equal to or greater than 110 percent of the value of the interest, or the strike price is equal to or greater than fair market value of the interest on the exercise date. The facts and circumstances determination whether an option holder has partner attributes includes whether the option holder has managerial rights in the partnership and rights to share in partnership profits through current and liquidating distributions, and has partnership obligations.

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

1. De minimis partners become substantial under proposed regulations. REG-109564-10, Partner's Distributive Share, 76 F.R. 66012 (10/25/11). The economic effect of a partnership allocation is not substantial under Reg. § 1.704-1(b)(2)(iii)(*a*) if, at the time the allocation (or allocations) becomes part of the partnership agreement: (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. Reg. § 1.704-1(b)(2)(iii)(*e*) provides that the tax attributes of a de minimis partner (a partner who owns less than 10 percent of partnership capital or profits) need not be taken into account in applying the substantiality tests. The proposed regulation would remove the de minimis partner rule "in order to prevent unintended tax consequences." The preamble to the proposed regulation indicates that the de minimis partner rule was "not intended to allow partnerships to entirely avoid the application of the substantiality regulations if the partnership is owned by partners each of whom owns less than 10 percent of the capital or profits, and who are allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit." The regulations will be effective when finalized.

a. De minimis partners are still partners under the substantiality test. T.D. 9607, Partner's Distributive Share, 77 F.R. 76380 (12/28/12). Reg. § 1.704-1(b)(2)(iii)(e) is amended to remove the de minimis rule that provided that in determining whether the economic effect of a partnership allocation is substantial under Reg. § 1.704-1(b)(2)(iii) the tax consequences to a less than 10 percent partner could be ignored. The final regulation is applicable to allocations that become part of a partnership agreement after 12/28/12, and is applicable for all partnership taxable years beginning on or after 12/28/12, regardless of when an allocation became part of the partnership agreement.

2. Only in tax law could insolvency result from debts you don't really have to repay. Rev. Rul. 2012-14, 2012-24 I.R.B. 1012 (5/25/12). Section 108(a)(1)(B) excludes COD from gross income if the cancellation occurs when the taxpayer is insolvent; § 108(a)(3) limits the amount of COD income excluded by § 108 to the amount by which the taxpayer is insolvent. Rev. Rul. 92-53, 1992-2 C.B. 48, provides that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt ("excess nonrecourse debt") is treated as a liability in determining insolvency for purposes of § 108 to the extent that the excess nonrecourse debt is discharged. Revenue Ruling 2012-14 holds that for purposes of measuring a partner's insolvency under § 108(d)(3), each partner treats as a liability an amount of the partnership's discharged "excess nonrecourse debt" that is based upon the allocation of COD income to such partner under § 704(b) and the regulations thereunder.

3. Retention of an economic interest is not a liquidation. Brennan v. Commissioner, T.C. Memo. 2012-209 (7/23/12). Ashland and Brennan were members of the Cutler & Company LLC, which managed asset portfolios for high-income individuals. (Another Cutler case is discussed under the partnership audit rules at VII.F.5., below.) Ashland was the CEO of Cutler. Cutler was restructured in 2002 because of "turmoil" among the members. Cutler sold certain institutional accounts under an agreement entered into in 2002, with payments made in 2003 and 2004. Sales proceeds were used to satisfy Cutler liabilities and obligations. At the time of the sale Brennan ceased to be a member of Cutler, but continued to hold "an economic interest" which conferred a continuing interest in income and loss items. Ashland reported capital gain from the sale in 2003, but none in 2004.

Brennan reported no capital gain from the Cutler sale. The IRS asserted inconsistent deficiencies against both Ashland and Brennan in order to avoid a whipsaw, asserting that Ashland was responsible for reporting all of the capital gains recognized in 2003 and 2004 and that Brennan was responsible for reporting his 45 percent distributive share of the capital gains. The Tax Court (Judge Kroupa) rejected Brennan's claim that his partnership interest terminated in 2002, holding that a retiring partner remains a partner for tax purposes until the partner's interest has been completely liquidated. Thus, the court held that Brennan was responsible for reporting his share of partnership capital gain derived in 2003 and 2004. Ashland was responsible for reporting her share of the capital gain as set forth in the 2002 restructuring agreement.

4. Family farm is a partnership. Holdner v. Commissioner, T.C. Memo. 2010-175 (8/4/10). When his son Randal expressed little interest in going to college, William Holder, an accountant, invested in developing a small family farm for his son to operate with an agreement to divide the profits with an undefined equity interest in the property. As the farming operation expanded, father and son took title to property as tenants in common. On his returns William reported one-half of the income and claimed deductions for all operating expenses. The Tax Court (Judge Marvel) held that the arrangement was a partnership, rejecting the taxpayer's arguments that they each operated as independent sole proprietors. Judge Marvel noted that both William and Randal contributed properties and labor to the venture which conducted business activities. She also found that the taxpayers failed to rebut a presumption that the partners shared equal capital interests in the partnership that applied to all items of income and expenditure, and that differing capital contributions did not justify an allocation of all expenditures to William. The court sustained an accuracy related penalty under § 6662 finding that William failed to make a reasonable attempt to ascertain the correctness of his reporting positions.

a. Not clearly erroneous says the Ninth Circuit. Holdner v. Commissioner, 483 Fed. Appx. 383 (9th Cir. 10/12/12). Affirming the Tax Court in an unpublished opinion, the Ninth Circuit upheld Judge Marvel's conclusion that the farming operation was a 50-50 partnership, as opposed to a mere co-ownership of property. It also rejected the taxpayer's argument that the Notice of Deficiency was not adequate because it failed to inform the taxpayer of what would be relevant at trial.

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. Partnership items are in the eye of the beholder. Petaluma FX Partners v. Commissioner, T.C. Memo. 2012-142 (5/17/12). On its own motion, the D.C. Circuit again remanded this case back to the Tax Court to reassess the Tax Court's holding in *Petaluma III* (135 T.C. 581) that it lacked jurisdiction to determine the partner's outside basis in the partnership proceeding because it is an affected item in light of the court's majority decision in *Tigers Eye Trading LLC v. Commissioner*, 138 T.C. 67 (2/13/12), that it had jurisdiction in the partnership level proceeding to determine the partner's outside bases and assess penalties. Petaluma FX Partners, LLC v. Commissioner, 109 A.F.T.R.2d 2012-2238 (D.C. Cir. 2/27/12). The Court of Appeals cited the lone dissent by Judge Holmes where he stated that "[o]ur decision today overrules *Petaluma III*". In its supplemental memorandum decision, the Tax Court (Judge Goeke) indicated that the decision on remand in *Petaluma* was based on the "narrow" instruction on remand from the D.C. Circuit which established the law of the case and further stated that its decision on remand was "thoroughly imbued with the legal reasoning and logic provided by the D.C. Circuit in its earlier decision." The court also stated that the language from Judge Holmes's dissent in *Tigers Eye* that was cited in the D.C. Circuit's remand does not represent the position of the court and indicated that no part of the opinion in *Tigers Eye* "purported to explicitly alter or overrule the decision in this case or to revise the language of the Court's Opinion in *Petaluma III*."

2. TEFRA audit rules bar Tax Court consideration of a guaranteed payment of a small partnership with a pass-through member. Brennan v. Commissioner, T.C. Memo. 2012-187 (7/9/12). In consolidated cases, the Tax Court (Judge Kroupa) determined that it lacked jurisdiction under the TEFRA audit rules to determine whether the taxpayers were entitled to flow-through losses attributable to guaranteed payments. The involved parties were members of Cutler & Company LLC, which managed asset portfolios for high-income individuals. Ashland was the CEO of Cutler. Ashland and Brennan transferred their Cutler interests to a general partnership, Airport Plaza (AP), which was to dissolve under its own terms at the end of 2001. The Cutler operating agreement in 2002 identifies AP as a Cutler member. Cutler was restructured in 2002 because of "turmoil" among the members. AP's 2002 partnership return claimed a partnership loss for 2002 attributable to a guaranteed payments to Brennan of $4,785,616 and Joseph Furey a former Cutler member, of $485,000. Ashland claimed her share of the loss from AP on her 2002 return. In a petition contesting the IRS disallowance of the loss, Ashland asserted in an amended petition to the court that the guaranteed payments were in fact made by Cutler and that Ashland was entitled to a pass-through loss from Cutler for the payments. The Cutler 2002 partnership return, signed by Ashland as CEO, reported the payments as guaranteed payments to Brennan and Furey. The court agreed with the IRS that Cutler was a TEFRA partnership so that the status of guaranteed payments by Cutler was a partnership item, determinable only in a TEFRA proceeding. A petition for administrative adjustment of Cutler's 2002 return was barred by the statute of limitations. The court rejected the taxpayer's assertion that Cutler was a small partnership (fewer than ten members) because the small partnership exception does not apply under § 6231(a)(9) to a partnership that has a pass-through entity as a member. The court did not allow Ashland to disregard her chosen form of operating AP as a partnership and reporting partnership returns. In addition the court found that AP was treated a member of Cutler in spite of Ashland's argument that Cutler membership interests were never formally transferred to AP because of stipulations by Ashland to the contrary and the Cutler operating agreement unambiguously including AP as a member.

3. A Notice of Deficiency relating to the partner level loss limitation rules need not wait for an FPAA. Meruelo v. Commissioner, 691 F.3d 1108 (9th Cir. 8/16/12, as amended 11/14/12). The taxpayer reported losses from a single-member LLC (disregarded entity) that was a partner in Intervest, which reported losses from foreign currency transactions. Neither the Intervest returns nor the taxpayer's individual returns identified the status of the disregarded LLC. Although the IRS was investigating Intervest for fraud, and there was a related grand jury proceeding, the IRS did not notify Intervest that it would begin an audit, nor did it issue an FPAA for the year at issue. The IRS issued a notice of deficiency to the taxpayers shortly before the three-year statute of limitations would have expired with respect to their individual returns. Affirming the Tax Court, 132 T.C. 355 (2009), the Court of Appeals (Judge N.R. Smith) held that even though application to a partner of the loss limitation rules of §§ 704(d) and 465 are affected items that require a partner-level determination, a notice of deficiency to a partner based on the application of the loss limitation rules of §§ 704(d) and 465 was not issued prematurely and was valid. The Tax Court had jurisdiction over the petition. While the TEFRA audit rules require completion of partnership proceedings when a partnership item or a related item is involved before issuing a notice of deficiency to partners, the court held that TEFRA does not limit the issuance of a notice of deficiency when no partnership proceeding is pending and no notice of deficiency has been sent. The court also stated that although § 6225(a) provides that "'no assessment of a deficiency attributable to any partnership item may be made . . . before' 150 days after the date a notice of FPAA is mailed or a proceeding in Tax Court has been finalized[,]" [a]ssessment of a deficiency is not equivalent to providing notice of a deficiency." The court also rejected the taxpayer's argument that the notice of deficiency was improper when issued because the IRS was considering a criminal investigation that might have found fraud. The court held that the IRS's contemplation of initiating future proceedings is irrelevant and that requiring the IRS to prove that it had no interest in future partnership-level proceedings would serve no purpose.

4. Asset management joint venture is not a partnership, so take that ordinary income. Rigas v United States, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). Hydrocarbon Capital, LLC, which held a number of oil and gas industry financial assets, entered into a loan management and servicing agreement (specifically stating the arrangement was not a partnership) with Odyssey Energy Capital I, LP, formed by five individual limited partners with an LLC general partner. The management agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio, and a 10 percent preferred return. In a claim for refund, the taxpayer, one of Odyssey's limited partners, claimed pass-through capital gain treatment on gains from disposition of the managed assets. The District Court (Judge Ellison) agreed with the IRS determination that the income to the Odyssey partners was ordinary income as a service fee rather than pass-through partnership income from a joint venture with Hydrocarbon. The court indicated that notwithstanding the unambiguous text of the management agreement eschewing partnership status, it may still look to the conduct of the parties to determine whether the arrangement was a partnership. The court indicated that the Odyssey partners contributed both capital and services to the relationship with Hydrocarbon, and the arrangement provided for a profit sharing and some risk of loss for the Odyssey partners, which supported treating the arrangement as a partnership. Odyssey maintained significant management responsibility for the Hydrocarbon assets, but it did not have authority to withdraw funds from Hydrocarbon bank accounts, it could not increase Hydrocarbon's capital commitment to a particular asset, it could not enter into binding agreements in Hydrocarbon's name, and it could not dispose of an asset without Hydrocarbon's written approval. Odyssey did not share control over bank accounts that corresponded to companies in the asset portfolio, nor could it disburse funds from the accounts, and thus lacked control over the assets and income of the venture. Finally, the court pointed to the fact that neither Hydrocarbon nor Odyssey filed tax returns treating the arrangement as a partnership. Thus, the court found that the IRS established by a preponderance of the evidence that a partnership did not exist.

- The court also held that it had jurisdiction to consider the taxpayer's refund claim under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed form 8802 as required by the regulations.

a. The Fifth Circuit reverses the District Court but the taxpayer still loses. This case proves that the TEFRA audit rules are ridiculously complicated and result in a Catch-22. Rigas v. United States, 486 Fed. Appx. 491 (5th Cir. 8/21/12). The taxpayer was one of five limited partners in Odyssey Energy Capital I, LP (Odyssey), which entered into a loan management and servicing agreement with Hydrocarbon Capital, LLC. The agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio and a 10 percent preferred return. The agreement specifically stated that the arrangement was not a partnership. In 2004 Hydrocarbon recognized approximately $110 million of gain on disposition of assets and paid a performance fee to Odyssey of approximately $20 million. Odyssey originally reported the $20 million as a management fee constituting ordinary income, and the Odyssey partners reported their share of the ordinary income on individual returns. Subsequently Odyssey filed an amended return claiming it was in a partnership with Hydrocarbon and its $20 million share of proceeds was capital gain. The partners filed amended individual returns claiming refunds. Apparently the IRS allowed refunds to four partners, but denied Rigas's claim. In Rigas's refund suit, the District Court held that there was no partnership between Odyssey and Hydrocarbon and the fees paid to Odyssey were properly treated as ordinary income. *Rigas* *v United States*, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). The District Court also held that it had jurisdiction to consider the taxpayers' refund claims under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed Form 8802 as required by the regulations. With a complicated meander through the limitations on filing refund actions by partners under TEFRA, the Fifth Circuit in a lengthy per curiam opinion reversed the District Court's holding that it had jurisdiction to hear the refund action, denied the taxpayer's claim that he was entitled to consideration of whether the partnership item was capital gain, held that the District Court had jurisdiction to determine whether the taxpayer was given inconsistent settlement treatment, but alas concluded that there was no settlement.

- Section 7422(h) bars jurisdiction to consider a refund claim by a partner attributable to partnership items except as provided in §§ 6228(b) or 6230(c). Section 6228(b) allows a refund suit attributable to partnership items if the IRS responds to a partner's Administrative Adjustment Request (AAR), filed as provided in § 6227(d), by mailing a notice indicating that partnership items will be treated as non-partnership items, or if the IRS fails to allow the AAR and no notice is mailed. Section 6230(c) provides for claims arising from erroneous computations and was not at issue in the case. The Court of Appeals rejected the District Court holding that the taxpayer's filing an amended return was substantial compliance with the AAR requirement. The court held that the requirement of Reg. § 301.6627(d)-1 that the taxpayer file a specific form (Form 8082) is a procedural requirement that may be met with substantial compliance, but that the requirement that the taxpayer provide a detailed explanation of the claim is a substantive requirement that must be satisfied so that the IRS can properly decide whether to allow the AAR. The court held that Rigas' amended return failed to meet the substantive requirements because it had not been filed in the Service Center where the partnership return had been filed, and it did not provide a detailed explanation of the claim for refund.

- The court held that a partner's claim to settlement terms consistent with the terms of a settlement between the IRS and another partner under § 6224(c)(2) is an item that depends upon whether the particular partner has been properly offered consistent settlement terms and is, therefore, not a partnership item. Thus, the court has jurisdiction to consider a refund claim on that basis. However, the court concluded that as a matter of law the IRS's payments of refunds to the other Odyssey partners were not settlement agreements under § 6224 because there was no partnership-level administrative proceeding.

- Finally, the court rejected the taxpayers alternate claim that since the character of the income was adjusted at the partnership level in the partnership amended return, the taxpayer is entitled to tax treatment consistent with the treatment of the partnership item. The court held that the District Court lacked jurisdiction to consider a refund claim on this basis under § 7422(h) because when the taxpayer "claim that the Performance Fee was recharacterized as capital gains instead of ordinary income at the partnership level and that they are entitled to a refund based on a similar characterization at the partner level, their claim is attributable to a partnership item." The court noted in support of its finding that the item is a partnership item that characterization of the performance fee at the partnership level affects both the partnership's reporting and the reporting of the other partners.

5. Penalties assessed on outside basis adjustments are not a partnership item. Arbitrage Trading, LLC v. United States, 111 A.F.T.R.2d 2013-409 (Fed. Cl. 1/30/13). Following *Petaluma FX Partners*, and *Tigers Eye Trading LLC*, the Court of Federal Claims held in this Son of Boss TEFRA proceeding that the court lacked jurisdiction to consider the application § 6662 accuracy related penalties on adjustments to the taxpayer's outside basis, which is an affected item in the partnership proceeding. The court further held that it had jurisdiction to consider accuracy related penalties related to adjustment of the disregarded partnership's losses and other deductions.

6. Rely on the IRS for legal advice, you lose. Kearney Partners Fund, LLC v. United States, 111A.F.T.R.2d 2013-___ (M.D. Fla. 3/27/13). The taxpayer invested in a tax shelter scheme called "Family Office Customized" (FOCus) program" by acquiring a direct interest in an LLC called Nebraska Partners, which included indirect interests in Lincoln Partners LLC owned 99% by Nebraska, and Kearney Partners LLC, owned 99% by Lincoln. On initiation of a TEFRA audit procedure (which the court referred to as "TERFA"), the IRS mailed required Notice of Beginning of Administrative Proceedings (NBAP) to the partnerships but not the partners. Section 6223(a) requires notice of initiation of an audit at least 120 days before issuance of a Final Partnership Administrative Adjustments (FPAA) to partners whose names and addresses are furnished to the IRS. Section 6223(e) allows a partner who was not provided a required notice to opt-out of the partnership proceeding. In issuing its FPAA to Kearney Partners, the IRS attached a cover letter indicating that since the taxpayer had not been issued an NBAP the taxpayer was entitled to opt-out of the partnership proceeding, which he elected to do. However, shortly after the taxpayer notified the IRS of his election to opt-out, the IRS sent a letter to the taxpayer indicating that it erred in informing the taxpayer of an election to opt-out because the taxpayer was not directly entitled to an NBAP in the first instance. The taxpayer's petition to the Tax Court following a separately issued notice of deficiency was dismissed for lack of jurisdiction but the basis for the decision was not specified. The District Court rejected the taxpayer's motion that the court lacked jurisdiction over the taxpayer in the partnership proceeding because of the taxpayer's election to opt-out. First, the court rejected the taxpayer's argument that the IRS was collaterally stopped from asserting jurisdiction in the partnership proceeding. The court concluded that since the basis for the Tax Court's determination that it lacked jurisdiction over the notice of deficiency issued to the taxpayer was not clear, the issue was not fully litigated in the Tax Court and, therefore, collateral estoppel did not apply. The court then found that the taxpayer was not initially entitled to receive an NBAP because the partnership failed either to provide the names and addresses of partners on a partnership return or by separate statement as required by § 6223(c). Further, the court held that the IRS is not required to search its records for other information that may be available to it that identifies the names and addresses of partners. That applies even if the IRS is aware of the partner's identity. Finally, the court indicated that, "While the Agency's error (subsequently rescinded) is regrettable to the extent it muddied the waters, it does not alter the fact that there was no legal obligation to provide the NBAP to [the taxpayer] in the first place and the letter to the contrary does not change that circumstance."

G. Miscellaneous

1. Hiding abusive shelter transactions behind disregarded entities makes the indirect partner an unidentified partner for statute of limitations purposes. Gaughf Properties L.P. v. Commissioner, 139 T.C. No. 7 (9/10/12). The taxpayers invested in KPMG/Jenkens & Gilchrist currency options tax shelters through a partnership consisting of two disregarded LLCs and a wholly owned corporation. After the IRS caught up with the taxpayers from information obtained through John Doe summons issued to Jenkens & Gilchrist, the IRS asserted that the statute of limitations remained open with respect to the taxpayers under § 6229(e), which extends the limitation period for one year after the name and address of a partner is furnished to the IRS where (1) the name, address, and TIN of the partner is not "furnished" on the partnership return, and the IRS has sent notice of an FPAA within the statute of limitations, or (2) the taxpayer has taken an inconsistent position and fails to provide the notice required by § 6222(b). The Tax Court (Judge Goeke) held that the statute remained open under both provisions. Following the holding in *Costello v. United States*, 765 F. Supp. 1003 (C.D. Cal. 1991), the court held that, although Schedule K-1s are required only for direct partners, an indirect partner who is not identified on a partnership return remains an "unidentified partner" for purposes of § 6229(e)(1). The court rejected the taxpayer's argument that because the IRS was in possession of identifying information from applications for taxpayer identification numbers for the disregarded entities (Forms SS-4) and information from Jenkens & Gilchrist and KPMG's John Doe summons more than one year before issuing assessment notices. The court upheld the validity of requirements in Temp. Reg.

§ 301.6223(c)-1T that information be "filed" with the IRS at the Service Center where the taxpayer's returns are filed and that the identifying information be specific. The court interpreted § 6229(e)'s use of term "furnished" as sufficiently close to the filing requirement of the temporary regulations to indicate that the regulation was a valid exercise of administrative authority under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) and § 7805(a).

- The court also held that the taxpayer took an inconsistent position on returns reporting the partnership transactions because of the way the partnership netted contributions of long and short options which the taxpayer reported separately in claiming basis increases. As a result, the taxpayer was found to have failed to provide the statement required by § 6222(b), thereby extending the statute of limitations under § 6229(e)(2).

- The court also rejected the taxpayer's arguments that the IRS was estopped from assessing a deficiency (1) because of IRS delays in issuing Notice 2000-44, 2000-2 C.B. 255 (notifying taxpayers of the issues raised by the shelter transaction); (2) because of the long period before the IRS issued an FPAA to the taxpayer's partnership; or (3) because the IRS had withheld and destroyed evidence or placed witnesses beyond the reach of the taxpayer because of criminal investigations.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. Had this opinion been issued on October 25th, the taxpayer might have had a chance. However, the opinion was issued on March 14th, so success was not in the cards. Crispin v. Commissioner, T.C. Memo. 2012-70 (3/14/12), on appeal to the Third Circuit. The taxpayer, an experienced CPA, entered into a CARDS transaction in 2001 to shield about $7 million of shared fees (ordinary) income from his wholly owned S corporation that engaged in a business related to a pool of collateralized mortgage obligations. The promoter was a longtime friend who did not charge the taxpayer any fee to participate in the CARDS transaction. The Tax Court (Judge Kroupa) held that the transaction lacked economic substance because it lacked business purpose and profit expectation, stating, "[w]e have consistently held that CARDS transactions lack economic substance," and noting that an appeal in this case lies in the Third Circuit, which decided *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

- Judge Kroupa also upheld the 40 percent gross valuation misstatement accuracy-related penalty. The tax opinion the taxpayer received from his advisors relied on "false representations [the taxpayer] made," including that he had a business purpose for entering into the CARDS transaction and that he anticipated earning a profit, absent tax benefits, from the CARDS transaction, which were "material to the conclusions reached in the tax opinion." Furthermore, the taxpayer had not actually relied on the opinion.

a. This opinion was issued on February 25th so the taxpayer was again out of luck. Crispin v. Commissioner, 708 F.3d 507 (3d Cir. 2/25/13). The Third Circuit (Judge Jordan) upheld the Tax Court determination that the CARDS transaction failed both the objective and subjective tests for economic substance. The Third Circuit further found that the Tax Court did not abuse its discretion in deciding not to credit either taxpayer's evidence as to business purpose [in that he approached the lender to substitute aircraft for cash as collateral] or the expert opinion by taxpayer's expert [in that potential profit could be generated by using the CARDS loan proceeds to purchase aircraft]. The penalty issue was decided against taxpayer, following *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 9/28/12).

2. You better hope that your H-P computer works better than H-P's tax planning

strategies. Hewlett-Packard Co. v. Commissioner, T.C. Memo. 2012-135 (5/14/12). In a complicated transaction designed by AIG-Financial Products to generate foreign tax credits, Hewlett-Packard purchased a preferred stock interest in a foreign entity called Foppingadreef (FOP) that was to engage in a U.S.-dollar linked Netherlands guilder stepped coupon contingent note transaction which took advantage of asymmetric treatment of contingent interest in the U.S. and the Netherlands. The common stock of FOP was held by the Dutch bank, ABN, which also provided capital to FOP through transactions structured as a loan to an AIG subsidiary which in turn transferred the Dutch guilder proceeds to FOP along with an obligation on the part of FOP to pay contingent interest back to ABN. Hewlett Packard treated FOP as a controlled foreign corporation through its ownership of the preferred stock and warrants to acquire additional stock and claimed foreign tax credits for Dutch taxes. The transaction was structured to terminate in 2003 through the exercise of put options to transfer Hewlett-Packard's stock interest back to ABN for a price that resulted in a loss to Hewlett-Packard. The Tax Court (Judge Goeke), applying the multiple factors used to distinguish debt from equity, found that the structure of the transaction resulted in a fixed repayment of Hewlett-Packard's investment on a fixed date and treated the investment as a loan rather than an equity interest in FOP, thereby disallowing claimed foreign tax credits. The court also disallowed Hewlett-Packard's claimed § 165 loss on the difference between its initial investment and the price it received on the termination date. The court agreed with the IRS's assertion that Hewlett-Packard's claimed $15.5 million loss on termination of the transaction was in effect a fee paid to AIG in order to participate in a tax shelter. The court held that fees spent for the generation of artificial tax losses are not deductible as payments incurred in a transaction that lacked economic substance citing *Enrici v. Commissioner*, 813 F.2d 293, 296 (9th Cir. 1987), and *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161, 186 (2009), *aff'd*, 408 Fed. Appx. 908 (6th Cir. 2010). The court also noted that Hewlett-Packard failed to meet its burden of proof regarding the proper timing of the deduction.

3. "A [contingent liability section 351] transaction that would let [the taxpayer] deduct an approximately $38 million tax loss on the sale of $11,000 in securities which had just recently been purchased for the same amount ... would clearly appear to be too good to be true," said Judge Marvel in a decision rendered nine years after the trial. At long last, this is the first case to apply § 351(g). Gerdau MacSteel, Inc. v. Commissioner, 139 T.C. No. 5 (8/30/12). To shelter capital gains of over $41 million recognized on the sale of two subsidiary corporations in 1997, the taxpayer (Quanex), which was the parent in a consolidated group, entered into a tax shelter transaction devised and recommended by Deloitte & Touche that was intended to create an artificial short-term capital loss of approximately $38 million to offset the capital gains, called the "Double Deducting Environmental and Other Contingent Liabilities" (DDCL). The loss was to be created in a series of transactions involving Quanex's liabilities under for its medical plan benefits (MPBs). In simplified form, the transaction involved the following steps using two of Quanex's inactive subsidiaries (QS and QHMC): (1) Quanex caused QHMC to be recapitalized to have multiple classes of stock, including Class B and Class C voting preferred stock, (a) each with "an assumed $100 issue price," (b) cumulative dividends of 9.5%, payable quarterly, providing Quanex or QHMC with rights to call the preferred stock after five years and providing the Class C shareholders with rights to put the preferred stock after seven years, and (c) providing for a liquidation value for the Class C stock in amount equal to the greater of $125 or an amount equal to the lesser of a percent of any cumulative cost savings in MPBs or of QHMC's book net equity; (2) Quanex transferred $38,000,000 to QS, which assumed Quanex's contingent liability to pay MPBs under Quanex's benefits plan which were treated as being in the amount of $37,989,000; (3) QS transferred $38 million to QHMC, which in turn assumed the liability to pay Quanex's MPBs, in exchange for newly issued Class C stock, and (4) QS sold its Class C preferred stock to a former employee of a Q subsidiary for $11,000. The taxpayer took the position that the transfers of $38 million and the assumptions of liability were § 351 nonrecognition transactions and that pursuant to § 358(a)(2) and Rev. Rul. 95-74, 1995-2 C.B. 36, QS's basis in the QHMC stock was $38 million unreduced by the $37,989,000 of MPBs that were not deductible until paid. The taxpayer claimed a $37,989,000 loss recognized on the sale of the Class C stock that was used to offset the capital gains on the sales of the other subsidiaries. The Tax Court (Judge Marvel) found as facts that the transactions were structured in such a way that it was highly likely when the Class C stock was issued that the Class C stock would be redeemed within the five- and seven-year periods and that the redemption payment would be $125 per share. Judge Marvel further found that after the transactions, Quanex continued to process claims for MPBs, and its handling of the claims transferred to QHMC was the same as the handling of claims with respect to individuals whose MPBs were not transferred to QHMC. QHMC's reimbursements to Quanex for claims were made through intercompany entries recorded on Quanex's books as a receivable due from QHMC and on QHMC's books as a payable. QHMC lent the $38 million to an affiliated corporation, and QHMC eventually reimbursed Quanex for the MPBs when QHMC received payments on the loan. Based on the fact finding, Judge Marvel disallowed the loss deduction on two grounds.

- First, she held that because the Class C stock "'does not participate in corporate growth to any significant extent' within the meaning of I.R.C. sec. 351(g)(3)(A)," it was nonqualifed preferred stock (NQPS) as defined in § 351(g). The taxpayer and IRS had stipulated that if the Class C stock was found to be NQPS the claimed loss was not allowable. (The opinion does not explain the reason that the claimed loss was not allowable if the Class C stock was NQPS; however, § 351(g)(1)(A) provides that when NQPS is the only stock received, § 351(a) [and § 358] shall not apply to the transaction, and pursuant to §§ 1001 and 1012, the basis of the stock is equal to its fair market value.)

- The loss also was also disallowed under the economic substance doctrine, as was a § 162 deduction for $352,251 of fees incurred to effect the transactions. Judge Marvel found no business reason for assumption by QHMC of the MPB liabilities, the sale of the Class C stock, or any other aspect of the transactions; the transactions were all entirely tax motivated, for the purpose of generating an artificial loss. The court also upheld a § 6662(a) 20 percent accuracy penalty (and alternatively a substantial understatement penalty).

> [A] transaction that would let petitioners deduct an approximately $38 million tax loss on the sale of $11,000 in securities which had just recently been purchased for the same amount, and that this result, to a savvy, experienced businessman ... would clearly appear to be too good to be true.

- Thus, the reasonable cause exception of § 6664(c) was not available despite subsequent trial court decisions (later reversed on appeal) upholding tax plans similar to this one. But applying the *Golsen* rule, the court followed the Fifth Circuit's precedents in *Heasly v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408, and *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), *aff'g* 89 T.C. 912 (1987), in declining to sustain a 40 percent penalty asserted by the IRS, because the grounds underlying the court's disallowance of the capital loss deduction were not directly related to the taxpayer's valuation of the Class C stock or to the reporting of the proper basis therein.

4. Even though this D&T DDCL worked for a few years, double deductions are a "No No!" <u>Thrifty Oil Co. v. Commissioner</u>, 139 T.C. No. 6 (8/30/12). Thrifty was the common parent of a consolidated group for the relevant years (fiscal years ending 9/30/96 through 9/30/02), but only the years ending in 2000 through 2002 were at issue. During the fiscal year ending in 1996, Thrifty had generated and claimed a capital loss by causing a subsidiary (GW) to transfer a $29,100,000 note from another subsidiary (B) to yet another preexisting subsidiary (EM), which had assumed contingent environmental liabilities in transaction in exchange for 90 shares EM stock; this was done upon the advice of Deloitte & Touche. The taxpayer took the position that the transfer of the $29,100,000 note and the assumption of the $29,070,000 of contingent environmental remediation liabilities was a § 351 nonrecognition transaction and that pursuant to § 358(a)(2) and Rev. Rul. 95-74, 1995-2 C.B. 36, GW's basis in the EM stock was the $29,100,000 face value of the B note, without reducing the stock basis by the $29,070,000 of contingent environmental remediation liabilities EM assumed, which were not deductible until paid. Three days later (9/30/96), GW sold its EM stock for $25,200 and claimed a capital loss of $29,074,800. The taxpayer deducted a total of $18,347,205 of the capital loss on its 1996 through 1999 tax returns, years which were beyond the statute of limitations at the time the dispute in the case arose. The taxpayer claimed deductions for the remaining $10,727,595 of the capital loss on its 2000 through 2002 income tax returns, and those carryforwards were disallowed by the IRS. The sale of the 90 shares of EM stock had not broken EM's affiliation with the consolidated group, and in the years 2000 through 2002, the Thrifty group claimed § 162 deductions for $11,109,962 of environmental remediation expenses that were accruable in those years. The IRS disallowed the deductions. After stipulations — the taxpayer conceded the capital loss issue and the IRS conceded the deduction for environmental remediation expenses that had not previously been deducted in closed years as capital losses, as well as any penalties — the only issue for the court was the deductibility of the $11,109,962 of environmental remediation expenses from 2000 through 2002. The Tax Court (Judge Wherry) applied *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), and its progeny to disallow the deductions as "double deductions" that had been previously claimed as capital losses in the closed years 1996 through 1999. The court reasoned that under its applicable precedents and the applicable precedents in the Ninth Circuit, to which the case was appealable, "[i]f the deductions represent the same economic loss to [the taxpayer] and [the taxpayer] cannot point to a specific provision demonstrating Congress' [*sic*] intent to allow the double deductions, then the claimed environmental remediation expense deductions must be disallowed." Factually, there was a "double deduction" because "the capital loss arose not as a result of how basis was calculated but as a result of the contingent environmental remediation liabilities being taken into account in calculating the amount realized (or fair market value) but not in calculating basis." Furthermore, § 162, a general deduction provision, does not reflect a "clear declaration of intent" to allow a double deduction. Moreover, under Ninth Circuit precedent in *Stewart v. United States*, 739 F.2d 411 (9th Cir. 1984), as well as cases from other courts, it was immaterial to the application of *Charles Ilfeld Co.* whether the earlier deduction was proper or erroneous but not timely challenged by the IRS.

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

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

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

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

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

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

d. A small lagniappe to the taxpayers in a tax shelter. Klamath Strategic Investment Fund v. United States, 110 A.F.T.R.2d 2012-6021 (E.D. Tex. 9/24/12). On appeal, the Fifth Circuit Court of Appeals disallowed losses generated by a BLIPS tax shelter investment which was held to lack economic substance. *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009). The Court of Appeals remanded the case to the District Court to determine whether partnership operational expenses of $903,000 and fees for investment advice to the partner investors were deductible under § 212. Based on findings by the trial court, the Court of Appeals indicated that although the transaction lacked economic substance, the profit motive of the individual investors would permit the deduction of their economic outlays if the investors effectively controlled the partnership activities so that their profit motive would be attributable to the partnership. (The managing partners were held to have lacked the necessary profit motive to support the deductions.) The District Court (Judge Gilstrap) found that the partnerships were formed to effect an investment strategy selected by the investors, the managing partners were the managing partners "only because [the investors] made it so," the managing partners were confined to the investment strategy directed by the investors "who could shut down the whole process by withdrawing from the partnerships they had created." The court thus held that the investors were the parties having effective control over the partnerships. The court also held that $250,000 of investment fees paid to investment advisors who provided guidance with respect to the partnerships' foreign currency investments were deductible. The court concluded from its reading of the Court of Appeals remand that it had jurisdiction to order the refund in the partnership proceeding notwithstanding the fact that the expenses were not paid or incurred by the partnerships.

6. Taxpayer victory in the Court of Federal Claims in a lease-in, lease-out (LILO) transaction with a Dutch utility. On appeal, the taxpayer is likely to hit a Dutch wall, i.e., a [Timothy] Dyk. Consolidated Edison Co. of New York v. United States, 90 Fed. Cl. 228 (10/21/09). The Court of Federal Claims (Judge Horn), in a long and detailed opinion held that, under the particular facts of this case, the LILO transaction taxpayer entered into with a Dutch utility had economic substance, i.e., that no decision as to whether particular options would be exercised was "pre-ordained" and that taxpayer "bore the burdens and benefits of ownership." In finding that taxpayer had shown that the transaction was a true lease and should be respected, she distinguished factually other LILO cases decided for the government, such as *BB & T Corporation v. United States*, 523 F.3d 461 (4th Cir. 2008), and *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

- A large portion of the opinion consists of Judge Horn's analysis of the expert evidence, with pointed criticism of one expert who "failed to conduct in-depth studies of the … [t]ransaction and gave almost automatic and generalized conclusions on the flaws of LILO and SILO transactions for tax purposes."

- Alleged "spoliation of evidence" in 2000 by reason of a switch in e-mail systems without preserving all of the then-existing e-mails, and the desire to protect 1997 memoranda as work product, come into conflict with bad result for the credibility of an in-house lawyer. ("He was considered by the court an unreliable witness, perhaps willing to write or say whatever he thought would assist his then current assignment.") The court found that litigation was not reasonably anticipated until 2002 at the earliest because negotiations in connection with the IRS audit were ongoing until at least that year. The 1997 memoranda were ordered disclosed.

a. And, indeed, as expected, the shelter crashes against the Dutch Wall in the form of Judge Timothy Dyk! Consolidated Edison Co. of New York, Inc. v. United States, 703 F.3d 1367 (Fed. Cir. 1/9/13). In an opinion by Judge Dyk, the Federal Circuit reversed Judge Horn. The court applied the substance-over-form doctrine under its decision in *Wells Fargo & Co. v. United States*, 641 F.3d 1319 (Fed. Cir.2011), to conclude disallow ConEd's claimed deductions for rent and interest. Because there was a reasonable likelihood that the tax-indifferent entity in the LILO Transaction (the lessor of the master lease) would exercise its purchase option at the conclusion of the ConEd sublease, the master lease was illusory. Therefore, the LILO Transaction did not constitute a true lease and ConEd's rent deductions were disallowed. The interest deductions were disallowed because the loan proceeds effectively remained in an account to satisfy ConEd's loan obligation to the lender; ConEd did not have the use of the funds. Therefore, there was no genuine indebtedness. The case was remanded to the Court of Federal Claims for the limited purpose of determining only the refund of previously paid interest ConEd might be entitled to receive.

- While Judge Horn failed to stick her finger into the dike belonging to the Dutch utility, Judge Dyk shoved his thumb all the way into Judge Horn. In so doing, he also trashed the Deloitte & Touche appraisal report relied upon by ConEd.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

1. Not all losses are tax shelter losses. Rev. Proc. 2013-11, 2013-2 I.R.B. 269 (12/6/12). This revenue procedure provides that certain losses are not taken into account in determining whether a transaction is a reportable transaction for purposes of the disclosure rules under Reg. § 1.6011-4(b)(5). However, these transactions may be reportable transactions for purposes of the disclosure rules under Reg. § 1.6011-4(b)(2), (b)(3), (b)(4), (b)(6), or (b)(7). Among the losses not subject to § 6011 are losses (1) with respect to the sale or exchange of property where the basis was determined with respect to *cash* paid by the taxpayer, or under §§ 358, 1014, 1015, or 1031(d); (2) from fire, storm, shipwreck, or other casualty, or from theft, as those terms are defined for purposes of § 165(c)(3); (3) from compulsory or involuntary conversions as described in § 1231(a)(3)(A)(ii) and (a)(4)(B); (4) to which § 475(a) or § 1256(a) applies; (5) arising from hedging transactions described in § 1221(b), if the taxpayer properly identifies the transaction as a hedging transaction, or from a mixed straddle account under Reg. § 1.1092(b)-4T; (6) attributable to the abandonment of depreciable tangible property that was used by the taxpayer in a trade or business and that has a basis determined in clause (1), *supra*; (7) arising from the bulk sale of inventory if the basis of the inventory is determined under § 263A; and (8) that are equal to, and determined solely by reference to, a payment of cash by the taxpayer.

D. Tax Shelter Penalties, etc.

1. If it's "too good to be true," it ain't true. Gustashaw v. Commissioner, T.C. Memo. 2011-195 (8/11/11). In an opinion by Judge Halpern, the Tax Court upheld accuracy related penalties of over $1,000,000 against an investor in a CARDS tax shelter, with respect to which the investor had an opinion from Brown & Wood. Judge Halpern concluded as follows:

> A reasonable and ordinarily prudent person would have considered as "too good to be true" a carryover deduction generated from a previously claimed $9,938,324 tax loss when he did not suffer an associated economic loss and invested only $800,000 in the transaction. As such, he would have conducted a thorough investigation before claiming the deduction on his tax return. ...
>
> [The taxpayer] did not attempt to understand the mechanics of the CARDS transaction, executed the transaction documents without reading them and without an attorney's review, and, although aware of the transaction's untested tax ramifications, declined to seek a ruling from the IRS. Further, he did not question the claimed carryover loss amount even though he knew that he did not suffer an associated economic loss.

- Furthermore, Judge Halpern held that the taxpayer's reliance of the Brown & Wood opinion was "unreasonable" because he should have known that Brown & Wood had an inherent conflict of interest; the promoter of CARDS both referred Brown & Wood to the taxpayer and supplied him with a model tax opinion letter describing a CARDS transaction that was not unique to the taxpayer's situation. The was no evidence that the taxpayer had an engagement letter with Brown & Wood, spoke to any attorney at the law firm, or directly compensated Brown & Wood for a tax opinion letter. The taxpayer "could not have reasonably believed that Brown & Wood was an independent adviser."

a. Affirmed by Eleventh Circuit on the penalty issues. Gustashaw v. Commissioner, 696 F.3d 1124 (11th Cir. 9/28/12). The Eleventh Circuit (Judge Hull) affirmed the imposition of penalties, including the 40 percent gross valuation misstatement penalty despite the fact that the deduction was disallowed for lack of economic substance – refusing to follow the contrary rule of the Fifth and Ninth Circuits.

2. The Tax Court now agrees with the majority of circuits on the 40 percent gross valuation overstatement penalty, leaving the Fifth and Ninth Circuits standing alone together. AHG Investments LLC v. Commissioner, 140 T.C. No. 7 (3/14/13). In a unanimous reviewed opinion by Judge Goeke, the Tax Court overruled its prior decisions in *Todd v. Commissioner*, 89 T.C. 912 (1987), *aff'd*, 862 F.2d 540 (5th Cir. 1988), and *McCrary v. Commissioner*, 92 T.C. 827 (1989), and held that a taxpayer may not avoid a 40 percent gross valuation misstatement penalty under § 6662(h) by conceding a deduction or credit on grounds unrelated to value or basis of property. The Tax Court was persuaded that in its earlier cases it had misinterpreted a passage in the GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, which stated "The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement." Upon reconsidering the issue in

AHG Investments, the Tax Court quoted with approval the Federal Circuit opinion in *Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), which stated:

> The Blue Book, in sum, offers the unremarkable proposition that, when the IRS disallows two different deductions, but only one disallowance is based on a valuation misstatement, the valuation misstatement penalty should apply only to the deduction taken on the valuation misstatement, not the other deduction, which is unrelated to valuation misstatement.
>
> The court in Todd mistakenly applied that simple rule to a situation in which the same deduction is disallowed based on both valuation misstatement-and non-valuation-misstatement theories.

- The Tax Court holding in AHG Investments follows the rule adopted by the majority of the Circuit Courts of Appeal. See, e.g., *Fidelity International Currency Advisor A Fund LLC v. United States*, 661 F.3d 667 (1st Cir. 2011); *Alpha I LP v. United States*, 682 F.3d 1009 (Fed. Cir. 2012); and *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 2012). The Fifth Circuit and Ninth Circuit follow the rule that The Tax Court established in *Todd* but repudiated in *AHG Investments LLC. See Todd v. Commissioner,* 862 F.2d 540 (5th Cir. 1988); *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990).

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Proposed regulations on program-related investments. REG-144267-11, Examples of Program-Related Investments, 77 F.R. 23429 (4/19/12). The proposed regulations add nine examples depicting a wider range of investments that qualify as program-related investments. The new examples demonstrate that a program-related investment may accomplish a variety of charitable purposes, such as advancing science, combating environmental deterioration, and promoting the arts. Several examples also show that an investment funding activities in one or more foreign countries, including investments that alleviate the impact of a natural disaster or that fund educational programs for poor individuals, may further the accomplishment of charitable purposes and qualify as a program-related investment.

2. Hock mir nicht kein CHNA![5] REG-106499-12, Community Health Needs Assessments for Charitable Hospitals, 78 F.R. 20523 (4/5/13). These proposed amendments to Reg. §§ 1.509(r)-1 through -7 provide detailed guidance to charitable hospital organizations on the community health needs assessment (CHNA) requirements, and related excise tax and reporting obligations, enacted as part of the Patient Protection and Affordable Care Act of 2010.

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

-establish written financial assistance and emergency medical care policies;

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

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

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[5] Or, chinik. Literally, "Don't knock my teakettle!" Or, "Stop bothering me!"

-conduct a community health needs assessment (CHNA) and adopt an implementation strategy at least once every three years. (These CHNA requirements are effective for tax years beginning after 3/23/12.)

B. Charitable Giving

1. Both their house and their claimed charitable contribution deduction went up in smoke. Rolfs v. Commissioner, 135 T.C. 471 (11/4/10). The taxpayers donated a home, but not the underlying land, to the local volunteer fire department to be burned down in a training exercise. The fire department could not use the house for any purpose other than destruction by fire in training exercises. The taxpayers claimed a charitable contribution deduction of $76,000 based on a "before and after" valuation, comparing the value of the parcel with the building intact and the value of the parcel after demolition of the building; they complied with all record keeping and substantiation requirements. The Tax Court (Judge Gale) upheld the IRS's denial of the deduction. First, based on expert testimony, he found that the taxpayers received a quid-pro-quo in the amount of $10,000, which was the value of the demolition services provided to them by the donee fire department. Second, he found that the building, with ownership severed from the land and burdened by the condition that it be removed, i.e., in this case demolished, had no value. The lack of value was established by the expert testimony of home movers, who testified that considering the costs of removal to another site, the modest nature of the home, and the value of nearby land, no one would purchase the home for more than a nominal amount, between $100 and $1,000, sufficient to render the contract enforceable. Applying the principles of *Hernandez v. Commissioner*, 490 U.S. 680 (1989), and *United States v. American Bar Endowment*, 477 U.S. 105 (1986), Judge Gale held that because the consideration received by the taxpayers exceeded the value of the transferred property, there was no charitable contribution. He rejected application of the "before and after" valuation method, because that method did not take into account the restrictions that would have affected the marketability of the structure severed from the land.

a. While the Tax Court opinion is very fact specific, the Court of Appeals affirmance looks to establish a broader principle. Rolfs v. Commissioner, 668 F.3d 888 (7th Cir. 2/8/12). In an opinion by Judge Hamilton, the Seventh Circuit affirmed the Tax Court's decision. The Seventh Circuit concluded that "proper consideration of the economic effect of the condition that the house be destroyed reduces the fair market value of the gift so much that no net value is ever likely to be available for a deduction, and certainly not here." The appellate court reasoned that "the fair market valuation of donated property must take into account conditions on the donation that affect the market value of the donated property," and that the Tax Court properly rejected the before-and-after method for valuing a donation of property conditioned on the destruction of the property. The valuation must take into account any reduction in fair market value that results from the condition. Moving and salvage, under which the house had no actual value, were analogous situations reasonably approximated the actual facts. The before-and-after valuation method proffered by the taxpayer was not appropriate, because the facts were not analogous to conservation easements, where that method typically is used; in this case the donation destroyed the residential value rather than transferring it.

b. Another burning house charitable contribution deduction goes up in smoke. Patel v. Commissioner, 138 T.C. No. 23 (6/27/12). In 2006 the taxpayers purchased residential property with the intention to demolish the house and construct a new one on the site. Shortly after purchasing the property, the taxpayers obtained a demolition permit and executed documents granting the local fire department the right to conduct training exercises on the property and to destroy the house by burning during the exercises. Soon thereafter live fire training exercises were conducted, and the house was destroyed. The taxpayers claimed a noncash charitable contribution of $339,504 for the donation of the house to the fire department, but the IRS disallowed the deduction on the ground that the donation was a contribution of a partial interest in property, a deduction for which is denied by § 170(f)(3). In a reviewed opinion by Judge Dawson, the Tax Court granted summary judgment for the

IRS and upheld the denial of the deduction. The court reasoned that under the controlling (Virginia) state law, the taxpayers had merely granted the fire department a license to conduct training exercises on the property and to destroy the building, which did not convey any interest in the building to the fire department. In doing so, they conveyed only a partial interest in the land. Section 170(f)(3) thus denies any charitable contribution deduction for the donation of the use of the property regardless of the value of that use. However, the taxpayers acted with reasonable cause and in good faith and were not liable for any accuracy-related penalty under §§ 6662(a) or (h), because at the time they filed their return, *Scharf v. Commissioner*, T.C. Memo. 1973-265, which held that a charitable contribution deduction was available for the donation of a building to a volunteer fire department for demolition in firefighter training exercises, was the only relevant case law.

- An appendix explained that a license does not convey an interest in the property under the common law in any state or the District of Columbia.

- Judges Colvin, Cohen, Vasquez, Thornton, Marvel, Gustafson, and Morrison joined in the opinion of the court. Judge Paris concurred in the result only.

- Judge Gale, in an opinion joined by Judges Halpern, Foley, Goeke, Wherry, Kroupa, and Holmes, dissented. The dissent reasoned that the taxpayers had not merely granted a license, but "by virtue of the fire department's severance and destruction of the house, petitioners in substance ceded all substantial property interests they held in the structure to the department." Citing *Rolfs v. Commissioner*, 668 F.3d at 888 (7th Cir. 2012), *aff'g* 135 T.C. 471 (2010), in which Judge Gale wrote the Tax Court opinion, the dissent noted that to be entitled to a charitable contribution deduction, the taxpayers "must show that the value of the house, taking into account the conditions on its donation, exceeded the value of the benefit they received from the fire department in the form of demolition services." Thus the dissenters would have denied the motion for summary judgment and proceeded to trial on that fact question.

- Judge Kerrigan dissented but did not join in Judge Gale's dissent or write separately.

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

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

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

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

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

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

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

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

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

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

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

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

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

4. What part of "perpetuity" don't you understand?! Belk v. Commissioner, 140 T.C. No. 1 (1/28/13). The taxpayers claimed a charitable contribution deduction for the grant of a conservation easement on 184.627 acres of a golf course to a qualified organization. Specifically, they agreed not to develop the golf course. However, the conservation easement agreement permitted the taxpayers, with the donee's consent, to remove portions of the golf course from the easement and replace them with property not theretofore subject to the conservation easement. The IRS disallowed the deduction, and the Tax Court (Judge Vasquez) upheld the IRS's disallowance of the deduction. Section 170(h)(1)(A) requires the contribution of a "qualified" real property interest, and to be a "qualified" real property interest, § 170(h)(2)(C) requires that the conservation easement limit in perpetuity the use that may be made of the property. Section 170(h)(2)(C) precluded the deduction because the taxpayers did not donate an interest in real property subject to a use restriction granted in perpetuity. The interest in real property was not subject to a use restriction granted in perpetuity. Because the conservation easement agreement allowed the parties to change the property subject to the conservation easement, it did not meet the perpetuity requirement. The court rejected the taxpayers' argument the deduction nevertheless should be allowed because the substitution clause permitted only substitutions that would not harm the conservation purposes of the conservation easement. The court reasoned that the § 170(h)(5) requirement that the conservation purpose be protected in perpetuity is separate and distinct from the § 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity, and the taxpayers' conveyance failed to satisfy § 170(h)(2)(C). Satisfying § 170(h)(5) does not necessarily affect whether there is a qualified real property interest. Furthermore, it was argued that any substitution required the donee's consent:

"There is nothing in the Code, the regulations, or the legislative history to suggest that section 170(h)(2)(C) is to be read to require that the interest in property donated be a restriction on the use of the real property granted in perpetuity unless the parties agree otherwise. The requirements of section 170(h) apply even if taxpayers and qualified organizations wish to agree otherwise."

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

5. If the donee messes up on the written acknowledgement, your only recourse is to have the chaplain punch your Tare Sugar chit [Tango Sierra chit, if you were in the military after the 1950s] because Judge Cohen won't help you. Durden v. Commissioner, T.C. Memo. 2012-140 (5/17/12). A letter from taxpayers' church, dated 1/10/08, acknowledged numerous contributions during 2007, mostly in amounts of $250 or more, totaling $22,517; however the letter lacked a statement that no goods or services were provided to taxpayers in exchange for their contributions. A second letter from the church contained that statement but was dated 6/21/09 – after the IRS sent a notice of deficiency disallowing most of the claimed charitable contribution deductions. The Tax Court (Judge Cohen) held that the second letter was untimely and the first letter was insufficient, so the taxpayers' charitable contributions of $250 or more were disallowed under § 170(f)(8).

- Unless there are damning facts not reflected in the opinion, shouldn't there have been a better way for the IRS to have handled this matter?

6. You can't be your own appraiser, even if you might be qualified! "A taxpayer relies on his private interpretation of a tax form at his own risk." Mohamed v. Commissioner, T.C. Memo. 2012-152 (5/29/12). The taxpayer, a real-estate broker and certified real-estate appraiser, donated five real estate properties worth millions of dollars to a charitable trust. The taxpayer prepared his own tax return, including the Form 8283, Noncash Charitable Contributions, claiming charitable contribution deductions of over $3,000,000, even though the properties were worth over $15,000,000. The taxpayer left blank the Declaration of Appraiser because it stated, "I declare that I am not the donor, the donee, a party to the transaction," and he recognized that he was the donor (and the donee, since he was trustee of the Trust), but he did sign the Donee Acknowledgment saying that the Trust was a qualified organization under § 170(c) and that the Trust had actually received the claimed donations. The taxpayer also attached two statements to the tax return. The first was captioned "Statement of Explanation for Entry on Line 6 of Schedule A," and gave the addresses of the properties, more detailed descriptions of their size and improvements, and values for the properties. The second one, titled "Appraised Market Values," elaborated on the appraisal. He signed the second document, and under his signature indicated that his title was "Real Estate Broker/Appraiser." In the course of an audit over valuation, the taxpayer hired an independent appraiser whose valuations were relatively consistent with the taxpayer's valuations, but the IRS thereupon asserted that no deduction was allowable for failure to comply with the Reg. § 1.170A-13(c) substantiation requirements, which among other things require a "qualified appraisal," which under the regulations cannot be the donor or taxpayer claiming the deduction or the donee of the property. The taxpayer thus was not a qualified appraiser, and his attachments to the tax return did not qualify as the required appraisal summary that must be attached to the return because they failed to include information about several of the required categories on Forms 8283 and the attached statements. The Tax Court (Judge Holmes) granted summary judgment to the IRS, upholding the validity of the regulations — no surprise — and finding that the taxpayer had failed to satisfy the "substantial compliance" doctrine, because "[t]he cases make clear that substantial compliance requires a qualified appraisal," but excuses certain other minor deviations from the regulations requirements. Lastly, Judge Holmes rejected the taxpayer's "last-ditch effort" to save the deductions by arguing that Form 8283 for the years in question did not indicate that a taxpayer had to get an independent appraisal for contributions worth more than $5,000 and presented conflicting messages about what could be filled out by the taxpayer and what required an appraiser's signature. "We can't hold the form's failings against the Commissioner here, because 'the authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions and not in such informal publications.'"

7. **According to Judge Wells, you can write your own acknowledgment of the donee's receipt of your charitable contribution.** Averyt v. Commissioner, T.C. Memo. 2012-198 (7/16/12). The Tax Court (Judge Wells) held that a conservation easement deed reciting that the easement had been conveyed for "no consideration" satisfied the requirements of § 170(f)(8), even though the letter from the donee organization acknowledging the contribution did not satisfy § 170(f)(8) because it failed to state that no goods or services were received in exchange for the contribution. The letter recited that the taxpayer's sons had received "pens and pencils," which it was stipulated never had been received, but the letter nevertheless did not qualify, even though the pens and pencils would have had only nominal value, because the letters did not comply with the requirements of Rev. Proc. 90-12, § 2.05, 1990-1 C.B. 471, 472 (because the contribution was not pursuant to a fund-raising campaign).

- Section 170(f)(8)(B) provides that the contemporaneous written acknowledgment must include the following information: (i) The amount of cash and a description (but not value) of any property other than cash contributed; (ii) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i); and (iii) A description and good faith estimate of the value of any goods or services referred to in clause (ii). Section 170(f)(8)(C) defines a "contemporaneous" acknowledgment as one received on or before the earlier of: (i) the date on which the taxpayer files a return for the year when the contribution was made; or (ii) the due date for that return, including any extensions.

8. **Another case allowing the taxpayer to write the receipt. You just have to remember to get it countersigned by the donee.** RP Golf, LLC v. Commissioner, T.C. Memo. 2012-282 (10/3/12). The Tax Court (Judge Paris) held that a conservation deed signed by donee trust's representative, as well as by donor, satisfied the § 170(f)(8) written acknowledgment requirement. The deed provided detailed description of property and easement, and was contemporaneous with donation. The deed "stated that the conservation easement was an unconditional gift, recited no consideration received in exchange for it, and stipulated that it constituted the entire agreement between the parties with respect to the contribution of the conservation easement." Accordingly, the "deed, taken as a whole, stated that no goods or services were received in exchange for the contribution."

9. **Maybe it's time for the IRS to stop trying to deny conservation easement deductions due to imaginary foot faults.** Irby v. Commissioner, 139 T.C. No. 14 (10/25/12). The Tax Court (Judge Jacobs) allowed a charitable contribution deduction for the contribution to a qualified organization, via a bargain sale, of conservation easements that placed on the use of property a variety of limitations that served to protect the relatively natural habitat for fish, wildlife, and plants and to preserve open space and agricultural resources. Although the donee was required to reimburse the government agencies that funded the bargain purchase price in the event it received proceeds if the land to which the easements related was condemned and the easements were extinguished, the conservation purpose for the easements was protected in perpetuity. The donee would have received its full share of the condemnation proceeds vis-a-vis the donor taxpayers, and there was no risk that the donors would reap a windfall in the event of condemnation. While the donee was required to reimburse the funding governments, the requirement of Reg. § 1.170A-14(g)(6)(i) that all of the extinguishment proceeds would be used by donee in a manner consistent with the conservation purposes of the original contribution was met because the reimbursement under the terms of the conservation deeds would enhance the ability of the funding governmental agencies to conserve and protect more land, since the reimbursed funds would be used for that purpose. Judge Jacobs rejected the IRS's argument that the

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deduction should be denied on the ground that the taxpayer's appraisal report was not a "qualified appraisal" because the report did not include explicit statements that the appraisal was prepared for income tax purposes.

> [T]he appraisal report in this case included all of the required information either in the appraisal or in the appraisal summaries attached to petitioners' respective returns—it included a discussion of the purpose of the transaction (i.e., that the purpose of the appraisal was to value the donation of a conservation easement pursuant to the terms of section 170(h)) . . . ; it stated that fair market valuation was to be used in determining the value of the property; and Form 8283 was properly filed with petitioners' respective returns. The IRS has not provided to the public a specific form for the tax purpose statement, and respondent has not proffered any instance where a suboptimal tax purpose statement, by itself, invalidated an otherwise qualified appraisal.

- Finally, Judge Jacobs rebuffed the IRS's argument that the deduction should be disallowed on the ground that the taxpayers did not obtain contemporaneous written acknowledgments from the donee indicating the amount of goods or services that received for the contribution. He concluded that collectively (1) the option agreement between the donors and the donee, (2) the Forms 8283 attached to the taxpayers' tax returns, (3) letters from the donee to the donors states that it was a qualified § 170(h) organization and would receive and hold the conservation deeds with respect to the parcels, (4) the settlement statements prepared by the title company in the transaction, which list the amounts paid as part of the bargain sale, and (5) the conservation deeds, which stated the source of funding for the bargain purchase, described the donated property, and listed the responsibilities and rights that the donors and donees had regarding the enforcement of the easement – all of which were prepared before the taxpayers' income tax returns were filed – contained sufficient information to constitute a contemporaneous written acknowledgment despite the absence of any statement that no services were received by the donors (because goods were received by the donors in their bargain sales).

10. Contributions to a disregarded entity owned by a charity. Notice 2012-52, 2012-35 I.R.B. 317 (7/31/12). This Notice holds that the IRS will treat a contribution to a disregarded single member LLC that is wholly owned and controlled by a U.S. charity as a charitable contribution to a branch or division of the U.S. charity.

11. No Mardi Gras beads from the Tax Court for this taxpayer. Whitehouse Hotel Limited Partnership v. Commissioner, 131 T.C. 112 (10/30/08). The Tax Court (Judge Halpern) held that, as a precondition to using the replacement cost approach to valuing real estate, the taxpayer must show that the property is unusual in nature and other methods of valuation, such as comparable sales or income capitalization, are not applicable. The income approach to valuation is favored only where comparable market sales are absent. On the facts, the value of the contribution of a conservation facade easement for an historic structure on the edge of the French Quarter in New Orleans was overstated. The accuracy-related penalty for gross overvaluation was proper because there was no good faith investigation into the value.

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

> In sum, the tax court erred in declining to consider the Maison Blanche and

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

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

b. Judge Halpern reconsiders the whole case in light of the Fifth Circuit decision and increases the allowable deduction by only $65,415, from $1,792,301 to $1,857,716. Whitehouse Hotel Limited Partnership v. Commissioner, 139 T.C. No. 13 (10/23/12). On remand, Judge Halpern elaborated at length on the proper valuation method to be used to value the building under the "before and after" method, and once again accepted the IRS's argument that the value of the property should be determined using a comparable-sales method. The comparable-sales method applied by Judge Halpern was based on the sales of buildings suitable for conversion into hotels based primarily on local sales data, rejecting the taxpayer's argument that non-local sales data should be taken into account. He again rejected both the taxpayer's reproduction-cost method and income method to valuation. Judge Halpern explained that "[t]he reproduction cost of an historic building usually bears little relationship to its present economic value. Such cost is usually far in excess of the cost of construction of a similarly sized modern structure, and may reflect the price of materials and workmanship that are no longer readily available." Because reconstruction of the Maison Blanche Building, if destroyed, would not have been a reasonable business venture, there was no probative correlation between the taxpayer's expert's estimate of the reproduction cost of the Maison Blanche Building and the fair market value of the property. Judge Halpern rejected the income valuation method because in this case, where there was no ongoing business, it was based on too many contingencies, was inadequately developed, and thus was too speculative, particularly where the value could be established by comparable sales. He did not reject the income method of valuation as a matter of law. He stated: "We have no difficulty with the process. Where we have difficulty is with petitioner's call to trust on their face [the taxpayer's expert's] judgments as to values to be input to his model." Judge Halpern also again found that the easement conveyance did not deprive the partnership or any subsequent owner of the ability to add stories to the top of the Kress Building or blocking views of the Maison Blanche facade. However, in light of the Fifth Circuit's directive, Judge Halpern determined the value of the facade conservation easement based on the before- and after-restriction values of the combined Maison Blanche and Kress Building property. He concluded that the value of the easement was approximately $1.86 million, rather than $1.79 million as determined in his first opinion. Responding to the Fifth Circuit's determination that he had misapprehended the properties highest and best use, Judge Halpern reasoned that "although the highest and best use of property may determine a ceiling on how much a willing buyer would pay for the property, it does not necessarily determine a floor on how little a willing seller would accept. . . . [T]he hypothetical willing buyer and the hypothetical willing seller who populate our standard definition of fair market value will not invariably conclude their negotiation over price at a price reflecting the value of the property at its highest and best use." He turned to auction price theory to conclude that in determining the fair market value of the property, which is the relevant benchmark, "the equilibrium price at which the willing buyer and the willing seller would meet would be somewhere between the value of the property taking into account its most productive use (i.e., its highest and best use) and the value of the property taking into account its second most profitable use." Accordingly, he rejected the taxpayer's argument that the valuation should be based on the use of the buildings as the shell of a luxury hotel, there being no scarcity of buildings in New Orleans suitable for development as luxury hotels. "Only if there were sufficient scarcity would the partnership . . . capture a piece of the economic return to luxury hotel development of the building's shell." Finally, based on the $1.86 million value, the claimed value of the exceeded 400 percent of the actual value and the § 6662(h) gross valuation misstatement penalty applied. The § 6664(c) reasonable cause and good-faith exceptions did not apply, because Whitehouse failed to make a good-faith investigation of the value of the easement and did not reasonably rely on an appraisal.

12. Congress wants old folks to give their IRAs to charity. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 208(b)(2), retroactively extends the allowance of Code § 408(d)(8) that permits taxpayers 70½ years or older to take a $100,000 IRA distribution and contribute it to charity without recognizing income and without affecting the charitable contribution limitation of § 170 to contributed distributions made in tax years before 1/1/14. In addition, taxpayers may elect to treat distributions made in January 2013 as made on 12/31/12. Taxpayers are also allowed to elect to treat any distribution in December 2012 as a qualified charitable distribution if the distribution was transferred in cash to a charitable organization by 1/31/13.

13. Let's go green for a few more years; contributions of conservation easements. The 2012 Taxpayer Relief (and not so grand compromise) Tax Act, § 206, extended through 2013 the provisions of Code § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher in tax years beginning after 12/31/05 of up to 100% of the taxpayer's taxable income. The limits under Code § 170(e) are 50% of the taxpayer's charitable conservation base over other allowable charitable contributions, 100% for farmers and ranchers, with a fifteen year carryforward.

14. You need an appraisal of the right property – here stock, and not real estate. Estate of Evenchik v. Commissioner, T.C. Memo. 2013-34 (2/4/13). The taxpayer donated shares of stock in a corporation to a charity. The donated shares constituted approximately 72 percent of the outstanding stock. The corporation's only assets were two apartment buildings. They attached appraisals for each building to their tax return, but never had obtained an appraisal of the stock. The Tax Court (Judge Holmes) upheld the denial of a charitable contribution deduction because the appraisals failed to comply with the qualified appraisal requirement in Reg. § 1.170A-13(c)(3)(ii). The appraisals valued the wrong property. The stock was the property that had to have been appraised. Furthermore the appraisals did not take into account the effect that the contribution of less than all of the stock might have had on value of the donated property. In addition, the appraisals failed to (1) provide sufficient description of property or (2) state the date or expected date of the contribution and the value of the property on those dates. Finally, the substantial compliance doctrine could not save the deduction. "This is not a case where the taxpayers provided most of the information but left out one insignificant datum. . . . This is a case where the appraisals had gaping holes of required information."

15. Quid pro quo can be in the favorable governmental action. Pollard v. Commissioner, T.C. Memo. 2013-38 (2/6/13). The Tax Court (Judge Jacobs) upheld the denial of a charitable contribution deduction for the conveyance to the county government of two conservation easements with respect to a 67 acre farm property that the taxpayer owned. The granting of the conservation easements to the county was part of a quid pro quo exchange for the county approving the taxpayer's subdivision exemption request that would allow him to build a second home on the property. Statements of the county commissioners during the course of public hearings indicated that the subdivision exemption would not have been approved if the taxpayer had not granted a conservation easement to the county. The approval of the subdivision exemption request was a substantial benefit to the taxpayer. He did not convey the conservation easements "for detached and disinterested motives but rather to secure a personal benefit."

16. Typos don't render a contemporaneous written acknowledgment defective. Crimi v. Commissioner, T.C. Memo. 2013-51 (2/14/13). The taxpayer conveyed a conservation easement to a qualified donee though a bargain purchase. After first dissecting all of the experts' report to expose their errors, the Tax Court (Judge Laro) determined that the value of the contribution. Turning to the question of whether the requirements of a contemporaneous written acknowledgment required by § 170(f)(8) and a qualified appraisal required by § 170(f)(11) had been met, the court found for the taxpayer despite imperfect documentation. The court rejected the IRS's argument that the written acknowledgment had not signed by a representative of the donee, finding that the signer was an agent of the donee. The court rejected the IRS's contention that a typographical error in the description of the property was grounds for denying the deduction in light of the fact that in the light of the fact that the appraisal and the Form 8283 attached to the return provided the accurate description of the contributed property. The court rejected the IRS's assertion that the contemporaneous written acknowledgment was defective because although it stated that the easement was valued at $2,950,000, in consideration for which the donee provided a cash consideration of $1,550,000, leaving a charitable contribution of $1.4 million, it failed to state to state whether the donee organization provided other goods, services, or valuable consideration. Finally, the court applied the substantial compliance doctrine to determine that the qualified appraisal requirement had been met despite the fact that the appraisal was for an earlier year because the taxpayer relied on a long-time CPA and tax advisor and had no reason to doubt them when they told him that an updated appraisal would not provide a different value. That a subsequent valuation prepared by the taxpayer's expert produced a value much higher than the earlier appraisal indicated that it was reasonable for the taxpayer to believe the earlier appraisal "was not stale in substance and thus a good appraisal."

17. If you are both the contributor and the president of the charity, you must send yourself a contemporaneous written acknowledgment. Note how our attention has been shifted from ferals to ferrets. Villareale v. Commissioner, T.C. Memo. 2013-74 (3/12/13). The taxpayer was a co-founder of NDM Ferret Rescue & Sanctuary, Inc. (NDM), an animal rescue organization that specializes in rescuing ferrets. During the year in issue, when she was NDM's president, she contributed $10,022 to NDM by electronic funds transfers. Twenty-seven contributions (totaling $2,393) were for less than $250 and 17 (totaling $7,629) were for $250 or more. The dates and amounts of the transfers are reflected in the taxpayer's and NDM's bank statements, but NDM never provided the taxpayer with a contemporaneous written acknowledgment containing a description of any property contributed, a statement as to whether any goods or services were provided in consideration, and a description and good-faith estimate of the value of any goods or services provided in consideration as required by § 170(f)(8). Accordingly, the Tax Court (Judge Vasquez) upheld the IRS's denial of the $7,629 of contributions that were for $250 or more. The court found it "immaterial" that taxpayer was on both sides of the transaction and rejected her contention that as the president of NDM "'it would have been futile to issue herself a statement that expressly provided that no goods or services were provided in exchange for her contributions.'" The deduction for the $2,393 of contribution that were in individual amounts of less than $250 was allowed.

- Do you remember? **A touch of *Cohan* [?], with a cap, for the Cat Woman's unreimbursed charitable volunteer expenses.** Van Dusen v. Commissioner, 136 T.C. 515 (6/2/11). The taxpayer claimed charitable contribution deductions for out-of-pocket expenses incurred in caring for "foster cats" as a volunteer on behalf of Fix Our Ferals, a § 501(c)(3) organization. The Tax Court (Judge Morrison) applied the "substantial compliance doctrine" to allow a deduction for expenses incurred by a volunteer providing services to a charitable organization, even though the taxpayer's records did not strictly meet the specific requirements of Reg. § 170A-13(a)(1). The taxpayer's documents were "legitimate substitutes for canceled checks," because they contained all of the information that would have been on a canceled check — the name of the payee, the date of the payment, and the amount of the payment. Although the regulation requiring substantiation records to reflect the name of the donee was not written with unreimbursed volunteer expenses in mind, because the amounts expended exceeded $250 and the taxpayer failed to satisfy requirements of § 170(f)(8)(a) and Reg. § 1.170A-13(f)(1) for substantiation in the form of a contemporaneous written acknowledgment from the charitable organization, the deductible amount for each separate expenditure was limited to $250.

- Query whether prudent planning in the future should be: "If it flies or floats, don't own – rent; if it barks or meows, don't adopt – foster."

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. The Steve Martin excuse[7] doesn't work in the Seventh Circuit. Failure to file for nearly twenty years isn't mere negligence. United States v. Collins, 685 F.3d 651 (7th Cir. 7/6/12). The defendant, who failed to file income tax returns for almost twenty years, was convicted of tax evasion. On appeal, he argued that the use of the Seventh Circuit pattern jury instructions for tax evasion was erroneous because they did not distinguish the crime of tax evasion from a "mere negligent failure to file a tax return." The Court of Appeals (Judge Sykes) affirmed, stating that "it's not remotely plausible to attribute a tax delinquency of almost two decades to mere negligence." A jury does not need to "be specifically instructed that 'willful' tax evasion requires more than a mere negligent failure to file a return."

2. The IRS tells you how to apologize for filing a frivolous return and get the penalty reduced, but only once. Rev. Proc. 2012-43, 2012-49 I.R.B. 643 (11/5/12). This revenue procedure describes the limited circumstances in which a person may be eligible for a one-time reduction of any unpaid § 6702 frivolous return penalty. If a person satisfies all eligibility criteria, including filing all tax returns and paying all outstanding taxes, penalties (other than under § 6702), and related interest, the IRS will reduce all unpaid § 6702 penalties assessed against that person to $500.

3. Instructions on how to rat yourself out. Rev. Proc. 2012-51, 2012-51 I.R.B. 719 (11/26/12). This revenue procedure updates Rev. Proc. 2012-15, 2012-7 I.R.B. 369 and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions). There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return.

4. Freedom for preparers to use taxpayer return information to increase their own profitability. T.D. 9608, Disclosure or Use of Information by Preparers of Returns, 77 F.R. 76400 (12/28/12). The Treasury has finalized Prop. Reg. §§ 301.7216-2(n) through 301.7216-2(p) (REG-131028-09, Amendments to the Section 7216 Regulations – Disclosure or Use of Information by Preparers of Returns), replacing Temp. Reg. §§ 301.7216-2T(n) through 301.7216-2T(p). 75 F.R. 94 (1/04/10). Reg. § 301.7216-2(n) allows preparers to compile, maintain, and use a list containing solely the names, addresses, e-mail addresses, phone numbers, taxpayer entity classification, and income tax return form numbers of taxpayers whose tax returns the tax return preparer has prepared, if the list is used only to contact the taxpayers on the list either (1) to provide tax, general business, or economic information for educational purposes, or (2) for soliciting additional tax return preparation services. Reg. § 301.7216-2(o) allows return preparers to use tax return information, subject to limitations to produce a statistical compilation of data described in Reg. § 301.7216-1(b)(3)(i)(B) for a purpose relating directly to the

[7] "I forgot."

internal management or support of the tax return preparer's tax return preparation business, or to bona fide research or public policy discussions concerning state or federal taxation; disclosure of the statistical compilation must be anonymous as to taxpayer identity, and may not disclose an aggregate figure containing data from fewer than ten tax returns. Reg. § 301.7216-2(p) allows return preparers to disclose return information without penalty for the purpose of a quality or peer review, but only to the extent necessary to accomplish the review. The information also may be used to perform a conflict of interest check.

5. Did Owen Fiore fraudulently "welch" on his taxes? Judge Holmes said "Yes." Fiore v. Commissioner, T.C. Memo. 2013-21 (1/17/13). The Tax Court (Judge Holmes) found that former estate planning lawyer Owen Fiore filed fraudulent 1996 and 1997 income tax returns; Fiore had pleaded guilty to evasion of 1999 taxes but claimed that he did not owe fraud penalties for the earlier years. Fiore had total control of the finances of his law firm and did not delegate even the most mundane tasks, e.g., preparation of checks for signature, to anyone else, but claimed that he simply was "a horrible recordkeeper." In a detailed and analytic opinion, Judge Holmes decided the issue on the ground that Fiore was short of cash during the 1996-1997 period and admittedly engaged in "willful blindness" to the possibility that he was underreporting his income. His opinion concludes:

> And with particular weight given to this willful blindness we find that the Commissioner has met his burden of proving by clear and convincing evidence that Fiore filed fraudulent returns. We cannot accept that a person of Fiore's intelligence, training, and experience was not aware when he filed his returns for 1996 and 1997 -- at a time when he knew his need for cash was ballooning -- that there was a high probability that he was underreporting his income. And we find that he deliberately avoided steps that would have confirmed that underreporting, since all he had to do was read his monthly bank statements to verify the accuracy of his estimates of taxable income that he put on his returns.

- From the website of Owen G. Fiore, JD:

> For over four decades, Owen Fiore was a tax and estate planning lawyer in California, representing families and business entities in developing and implementing tax sensitive wealth succession, preservation and management plans, including using FLPs, LLCs, corporations and trusts in planning. He also had an active practice in tax controversies, especially those involving gift and estate taxes, evidenced by being lead counsel in a number of Tax Court cases, such as *Cristofani, Schauerhamer* and *Fontana*.
>
> As the result of a personal income tax case leading to a plea agreement-based conviction and subsequent 14 months incarceration, Owen now is involved as a non-lawyer consultant to professional advisors and their clients in tax and estate planning matters. ***
>
> Owen lives in Syringa, ID with his wife, Mary Ann, enjoying being on the Middle Fork of Idaho's wild and scenic Clearwater River.

- Section 10.24(a) of Circular 230 provides that "A practitioner may not, knowingly and directly or indirectly: (a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service."

6. A sole shareholder gets 87 months of room and board from the federal government for fraudulently treating as independent contractors workers who were really employees. United States v. Deleon, 111 A.F.T.R.2d 2013-502 (1st Cir. 1/11/13). The First Circuit, in an opinion by Judge Stahl, affirmed the fraud conviction under § 7206(2), and various other criminal statutes, of a corporation's sole shareholder. The corporation paid most of its workers directly with checks and did not withhold payroll taxes from their wages or report or remit such taxes to the IRS. The shareholder told the tax preparers that the unreported payroll workers were independent contractors for whom she was not required to remit payroll taxes. The tax return preparers recorded the checks to individuals on the unreported payroll as a business expense and issued a Form 1099 to each of those workers. The shareholder will get room and board from the federal government for 87 months.

7. Taxpayer's reliance on his CPA, who did a little ($1.2 million) embezzling on the side, was reasonable; therefore, no penalties for underreporting income were imposed. Thomas v. Commissioner, T.C. Memo. 2013-60 (2/26/13). The Tax Court (Judge Gerber) stated the considerations for reasonable cause penalty avoidance based upon reliance upon a tax professional as follows:

> To establish reasonable cause through reliance on the advice of a tax adviser, the taxpayer must meet the following three-prong test, laid out in Neonatology Assocs., P.A. v. Commissioner, 115 T.C. at 98-99: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer relied in good faith on the adviser's judgment. Finally, petitioner bears the burden of proof with respect to the defenses to the accuracy-related penalties. See Higbee v. Commissioner, 116 T.C. 438, 447 (2001).
>
> Petitioner met and became familiar with Steeves, his tax preparer, during 2003 when they began working together in a real estate investment business. After working with Steeves for some time, petitioner began his own businesses, which involved the same type of business activity in which he had worked with Steeves. Steeves was a certified public accountant and had seven years of experience in the same type of businesses as petitioner. Petitioner, having worked with Steeves and being aware of his professional background and experience, exclusively relied upon him to maintain his records, handle his business financial matters, and prepare his returns. Under these circumstances we find that it was reasonable for petitioner to perceive Steeves as a competent professional and to rely on him.
>
> Petitioner was reasonable in his reliance upon Steeves to correctly and accurately prepare his books. Petitioner understood that those books were used in the preparation of his 2006 and 2007 income tax returns. In addition, petitioners provided Steeves with all other information Steeves requested that was necessary to complete their returns, including the amounts of mortgage interest and interest income and Forms W-2. Accordingly, petitioner was satisfied that Steeves had all necessary and accurate information needed to correctly prepare petitioners' income tax returns. We find that petitioner's efforts were sufficient to ensure his return preparer had adequate and accurate information.
>
> Finally, we consider whether petitioner relied in good faith upon Steeves' judgment. In the setting of this case, there came a time when petitioner had doubts about the accuracy and quality of Steeves' recordkeeping. Ultimately, petitioner believed that Steeves was guilty of theft, fraud, and misappropriation of his money. However, his doubts about Steeves' ability or honesty did not arise until sometime after the 2006 and 2007 income tax returns were filed and respondent was conducting an audit examination of the returns. At the outset of that examination, petitioner continued to believe in and rely upon Steeves, to whom petitioner gave a power of attorney to represent him before the IRS.
>
> Under these circumstances we hold that petitioner has carried his burden of showing reasonable reliance on the advice of a professional as a defense to the accuracy-related penalties for 2006 and 2007. Accordingly, petitioner is not liable for an accuracy-related penalty on any underpayment for 2006 or 2007.

B. Discovery: Summonses and FOIA

1. You can't hide your foreign bank account records behind the Fifth Amendment. In re M.H., 648 F.3d 1067 (9th Cir. 8/19/11), *cert. denied*, 133 S. Ct. 26 (6/25/12). M.H. was the target of a grand jury investigation seeking to determine whether he used secret Swiss bank accounts to evade paying federal taxes. The District Court granted a motion to compel his compliance with a grand jury subpoena *duces tecum* demanding that he produce certain records related to his foreign bank accounts. The District Court declined to condition its order compelling production upon a grant of limited immunity and, pursuant to the recalcitrant witness statute, 28 U.S.C. § 1826, held him in contempt for refusing to comply. The Ninth Circuit upheld the District Court order. The Court of Appeals held that "[b]ecause the records sought through the subpoena fall under the Required Records Doctrine, the Fifth Amendment privilege against self-incrimination is inapplicable, and M.H. may not invoke it to resist compliance with the subpoena's command." The records were required to be kept pursuant to the predecessor of 31 C.F.R. § 1010.420.

a. When the government asks, ya gotta pony up the name(s) on your foreign bank accounts, the account numbers, the name and address of the banks, the type of account, and the maximum value of each such account during each year. In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011, 691 F.3d 903 (7th Cir. 8/27/12). In an opinion by Judge Bauer, the Seventh Circuit held that the compulsory production of foreign bank account records required to be maintained under the Bank Secrecy Act of 1970 does not violate a taxpayer's Fifth Amendment privilege against self-incrimination. The required records doctrine overrode any act of production privilege. A grand jury subpoena seeking his bank records issued in connection with an investigation into whether he used secret offshore bank accounts to evade his federal income taxes was enforced.

b. A third decision going the same way. In re Grand Jury Subpoena, 696 F.3d 428 (5th Cir. 9/21/12). The Fifth Circuit (Judge Dennis), in reversing a district court, declined to create a circuit split and held that the required records doctrine applied; the individual was required to produce foreign bank records subpoenaed in the IRS's investigation into whether he used secret Swiss bank accounts [with UBS] to evade his federal income taxes. The court's reasoning was that the Bank Secrecy Act's record-keeping requirement is "essentially regulatory," the records sought are of a kind "customarily kept" by account holders, and the records have assumed "public aspects"; this is so even though one purpose of the BSA was to aid law enforcement officials in pursuing criminal investigations.

C. Litigation Costs

1. Shades of the nineteenth century. A written opinion in a case with $71 dollars at stake. Dale v. Commissioner, T.C. Memo. 2012-146 (5/22/12). In a case in which the IRS conceded that the taxpayer was entitled to attorney's fees under § 7430, Judge Kroupa held that a taxpayer may not recover "costs for secretarial and clerical work performed by a secretary ($37.50), an assistant ($23) and a 'staff' member ($10.50) (collectively, fees at issue)" that were not subsumed in the attorney's hourly rate.

D. Statutory Notice of Deficiency

1. The Eleventh Circuit reverses the Tax Court by reading Webster's Third New International Dictionary. Shockley v. Commissioner, 686 F.3d 1228 (11th Cir. 7/11/12). The Court of Appeals for the Eleventh Circuit (Judge Hull) reversed a Tax Court decision, T.C. Memo. 2011-96, in which the Tax Court held that if it determines that the deficiency notice with respect to which the petition was filed is invalid, then the period of limitations is not suspended. The Court of Appeals reasoned that the proposition that limiting this holding to only petitions filed in response to a valid deficiency notice "cannot be found on the face of the suspension statute, nor can it be squared with the plain language of the statute."

> Here, the breadth of § 6503(a)(1)'s plain language indicates the 2005 petition qualifies as a "proceeding in respect of the [SCC] deficiency." First, the proceeding need only be "in respect of" the deficiency, not seeking "a redetermination of" the deficiency. The phrase "in respect of" is particularly comprehensive, with one dictionary ascribing a definition of "as to; as regards; insofar as concerns; [or] with respect to." *Webster's Third New International Dictionary* 1934 (1993); *cf. Kosak v. United States*, 465 U.S. 848, 854, 104 S. Ct. 1519, 1523 (1984) (describing the phrase "arising in respect of" in a section of the Federal Tort Claims Act, 28 U.S.C. § 2680(c), as "encompassing"). This choice of phrase is in contrast to a closely related statute, § 6213(a), where Congress selected the more specific phrase "redetermination of" the deficiency. In our view, the phrase "in respect of" in § 6503(a)(1) requires only that the substance of the proceeding concern the deficiency.

- Presumably, the Tax Court will continue to follow its own precedent in future cases that are not appealable to the Eleventh Circuit.

2. Are you "outside of the United States" if you live in another country but are visiting the United States when a deficiency notice is sent to your U.S. post office box? Smith v. Commissioner, 140 T.C. No. 3 (2/28/13). Section 6213(a) gives the taxpayer 90 days, or if the notice is addressed to a person outside the United States, 150 days, after the mailing of a deficiency notice to file a Tax Court petition. Prior to August 2007, the taxpayer lived in San Francisco. In 2007, the taxpayer moved from San Francisco to Canada and became a permanent resident of Canada. However, she continued to own a home and maintained a post office box in San Francisco. In late December 2007, the taxpayer returned to San Francisco briefly to complete moving her furniture to Canada. While she was in San Francisco, the IRS mailed a deficiency notice relating to the year 2000 to her San Francisco post office box. The respondent stated that the taxpayer had until March 26, 2008 (i.e., 90 days), to file a Tax Court petition. The taxpayer failed to pick up the notice before returning to Canada on 1/8/08. On 5/2/08, the taxpayer received a copy of the deficiency notice, and on 5/23/08, she filed a Tax Court petition. The IRS filed a motion to dismiss for lack of jurisdiction, contending that the petition was not timely filed. P objects and contends that, pursuant to § 6213(a), she is entitled to 150, rather than 90, days to file a petition. In a reviewed opinion (7-1-5) by Judge Foley, the Tax Court held that the 150-day period applied to the taxpayer because at the time the deficiency notice was sent she was permanent resident of Canada. The majority cited *Hamilton v. Commissioner,* 13 T.C. 747 (1949), which held that "the 150-day period applies to a taxpayer who regularly resides outside the United States but who through fortuitous circumstance happened to be physically in one of the States of the Union on the particular day the deficiency notice was mailed to him."

- Judge Halpern, in a dissent joined by three other judges, would have held that the petition was not timely. The dissent reasoned that the taxpayer "was present in the United States for a two-week period bracketing both the mailing and delivery of the notice to her address (a U.S. address) last known to the Commissioner, and, in the light of the words actually used by Congress and the relevant case law, that is sufficient for me to conclude that the notice was not addressed to a person outside the United States." The dissent concluded that "the 150-day rule applies either when the taxpayer is out of the country or when the address on the notice is a foreign address," and that "out of the country means 'physically located outside the United States'" Under this reasoning "residence" is irrelevant. "Absence from the United States, resulting in delay, is what matters."

E. Statute of Limitations

1. Don't screw up your certified mail customer receipt. Stocker v. United States, 111 A.F.T.R.2d 2013-556 (6th Cir. 1/17/13). On 10/15/07, the taxpayers mailed an amended return requesting a refund for 2003; their 2003 tax return had been timely mailed on 10/15/04. The IRS acknowledged that it received the amended return on 10/25/07, but rejected the refund claim on the ground that the request was untimely under § 6511(a), asserting that the envelope was postmarked October 19 — four days late. The taxpayers could not avail themselves of the timely mailed, timely filed rule of § 7502(a) because they could not produce a postmarked envelope; this was because the IRS, by its own admission, had not retained the envelope in which the return had been received. Nor could they present the customer copies of a certified mail receipts, because although they claimed to have sent the amended return by certified mail, they had — in a tragic comedy or errors — failed to present to the post office the customers' copy of the certified mail receipt to get them date-stamped. The Sixth Circuit, in an opinion by Judge Rosen, held that the taxpayers were not entitled to introduce extrinsic evidence of timely mailing of the refund request. The court followed the decisions of other courts holding that the exceptions provided by § 7502 are "exclusive and complete." *See, e.g. Deutsch v. Commissioner*, 599 F.2d 44 (2d Cir. 1979), and other cases cited therein). The court noted that in any event, the extrinsic evidence put forward by the taxpayers "did not purport to establish the fact of significance under § 7502(a)(1) — namely, the 'date of the United States postmark' on their amended 2003 return — but instead is directed at the separate factual question of when they presented this return to the post office for mailing." Thus, the denial of the refund was upheld.

2. You must react quickly to a jeopardy assessment if you want judicial review. Abraitis v. United States, 111 A.F.T.R.2d 2013-1023 (6th Cir. 3/4/13). The Sixth Circuit, in an opinion by Judge Cook, held that the availability of judicial review under § 7429(b) requires that the taxpayer either have made a timely request for administrative review or exhausted administrative remedies prior to seeking judicial review of the jeopardy assessment. (The statute permits the taxpayer to seek judicial review within 90 days after either (1) the sixteenth day after the taxpayer's request to the IRS for administrative review or (2) the day the IRS notifies the taxpayer of its determination on administrative review.) Furthermore, the court held that the requirement in § 7429(a)(2) that the taxpayer's request for administrative review must be filed within 30 days after receiving the written statement from the IRS explaining the jeopardy assessment is not subject to equitable tolling.

F. Liens and Collections

1. Ca-ching! The IRS collects twice. Weber v. Commissioner, 138 T.C. No. 18 (5/7/12). In 2007 the taxpayer filed an income tax return for 2006 reporting an overpayment and elected to have it applied to his 2007 estimated income tax. However, the IRS had determined that the taxpayer was liable for a § 6672 penalty and instead applied the income tax overpayment to that penalty liability. In 2008 the trust fund tax liability was satisfied by third-party payments, and when thereafter the taxpayer filed his 2007 income tax return, he claimed a credit for the overpaid 2006 income tax, thereby reporting a 2007 income tax overpayment, and elected to have that asserted 2007 overpayment applied to his 2008 estimated income tax. The IRS adjusted the 2007 credits downward to eliminate the claimed 2006 income tax overpayment, thereby eliminating the overpayment for 2007, resulting in a balance due. This pattern was repeated when the taxpayer filed his 2008 income tax return in 2009, when he again claimed a credit for earlier overpaid income tax. When the taxpayer did not pay the balance due, the IRS issued a notice of proposed levy, and the taxpayer requested a CDP hearing. At the CDP hearing the taxpayer argued that the § 6672 penalty had been overpaid and that his income tax liability would be satisfied if that overpayment were applied to his income tax liability. The IRS rejected his argument and determined to proceed with the levy. The Tax Court (Judge Gustafson) held that the taxpayer was not entitled to apply the earlier income tax overpayment to his later income tax liability, because after application of the income tax overpayment to the § 6672 penalty liability, there was no 2006 overpayment available. Furthermore, in reviewing the CDP hearing, the Tax Court lacked jurisdiction to adjudicate the taxpayer's claim of a § 6672 penalty overpayment. Section 6330 – the statute conferring CDP jurisdiction on the Tax Court – has no provision conferring and delimiting any overpayment jurisdiction. Finally, the opinion described the many administrative problems that would arise from allowing a person against whom a § 6672 penalty had been assessed and collected to seek a credit (or refund) based on the assertion that the penalty had been "over-collected."

2. The whole is greater than the sum of the parts. Lewis v. Commissioner, T.C. Memo. 2012-138 (5/16/12). In this review of an IRS CDP determination to proceed with a levy, Judge Paris held that the IRS had abused its discretion. "While each individual defect on its own may be insufficient to support a holding that [the IRS] abused [its] discretion, the cumulative effect of such defects demonstrates that [the IRS] acted both arbitrarily and capriciously in rendering [its] determination." The IRS's argument sought "to quilt together a string of exceptions to account for [the] deviation from what one would consider a thorough review of [the taxpayer's] case. . . . Accordingly, the Court holds that the [IRS] abused [its] discretion in sustaining the proposed levy."

3. CDP hearings raising the issue of liability for tax at a CDP doesn't require antique common law pleading by the taxpayer. Fielder v. Commissioner, T.C. Memo. 2012-284 (10/4/12). The Tax Court (Judge Laro) rejected the IRS's argument that a taxpayer was precluded from challenging his liability for taxes in a CDP hearing because he did not raise the issue in the Form 12153 hearing request. Neither the statute nor Tax Court case law requires a taxpayer to raise the liability issue in the request for a CDP hearing. The statutory rule only limits the taxpayer's ability to contest the underlying tax liability at the CDP hearing if the taxpayer did not receive a notice of deficiency or otherwise had a prior opportunity to dispute the tax liability. The statute does not specify the time for raising the issue. The underlying liability should be considered if a taxpayer raises it at any time during a CDP hearing.

4. Does this case portend that most single-member LLCs are mere nominee owners on behalf of their single member? Berkshire Bank v. Town of Ludlow, 111 A.F.T.R.2d 2013-498 (1st Cir. 1/11/13). The First Circuit, in an opinion by Judge Stahl, affirmed a District Court decision holding that a tax lien against the owner of a single-member LLC (which was a disregarded entity) filed in 2009 was superior to judgment lien on land owned by the LLC arising in 2010. On the facts the LLC was a mere nominee for its owner: (1) the owner transferred the property to the LLC for no consideration; (2) no one else had any interest in the LLC, made decisions for it, or benefitted from its income, (3) the LLC operated out of its owner's home' (4) the owner exercised total control over the LLC's property and its development; (5) the owner had complete use and enjoyment of the property, as evidenced by his formulation and execution of the plan to subdivide the property and sell off the lots; (6) the LLC did not interfere with the owner's use of the property; (7) the owner used 10 to 15 percent of the revenue from the LLC to pay his personal expenses; (8) the owner of the LLC treated the property as if it belonged to him; (9) the owner testified that he set up the LLC and transferred title to the property solely to avoid legal liability "in case somebody got hurt on the property;" (10) the LLC's bank account was not in its own name, but in the owner's name.

5. The obligation to pay income taxes has priority over a religious obligation to tithe. Thompson v. Commissioner, 140 T.C. No. 4 (3/4/13). In reviewing a CDP hearing, the Tax Court (Judge Ruwe) held that it was not an abuse of discretion for the settlement officer to reject the taxpayer's contention that his (1) monthly tithing to his (the Mormon) Church and (2) monthly payments for his children's college expenses should be excluded from the monthly amount available to satisfy his unpaid tax liabilities. The court rejected the argument that failure to allow tithing as a necessary expense violated the taxpayer's First Amendment right to religious freedom and the Religious Freedom and Restoration Act of 1993.

> The Commissioner's interest in expeditiously collecting taxes is especially compelling given the specific facts of this case. Petitioner has a long history of not paying his income tax liabilities. As of the date of trial petitioner still had not paid his income tax liabilities for the taxable years 1992, 1995, 1996, 1999, and 2000. Additionally, respondent has

assessed trust fund recovery penalties under section 6672 against petitioner for seven different tax periods.

G. Innocent Spouse

1. The IRS is attempting to be more equitable in granting innocent spouse relief. Notice 2012-8, 2012-4 I.R.B. 309 (1/6/12). This notice provides a proposed revenue procedure that will supersede Rev. Proc. 2003-61, 2003-2 C.B. 296, which provides guidance regarding § 6015(f) relief from joint and several liability. The factors used in making § 6015(f) innocent spouse relief determinations will be revised "to ensure that requests for innocent spouse relief are granted under section 6015(f) when the facts and circumstances warrant and that, when appropriate, requests are granted in the initial stage of the administrative process." The revenue procedure expands how the IRS will take into account abuse and financial control by the nonrequesting spouse in determining whether equitable relief is warranted, because when a requesting spouse has been abused by the nonrequesting spouse, the requesting spouse may not have been able to challenge the treatment of any items on the joint return, question the payment of the taxes reported as due on the joint return, or challenge the nonrequesting spouse's assurance regarding the payment of the taxes. Furthermore, a lack of financial control may have a similar impact on the requesting spouse's ability to satisfy joint tax liabilities. Thus, the proposed revenue procedure provides that abuse or lack of financial control may mitigate other factors that might otherwise weigh against granting § 6015(f) equitable relief. The proposed revenue procedure also provides for certain streamlined case determinations; new guidance on the potential impact of economic hardship; and the weight to be accorded to certain factual circumstances in determining equitable relief.

- Until the revenue procedure is finalized, the IRS will apply the provisions in the proposed revenue procedure instead of Rev. Proc. 2003-61 in evaluating claims for equitable relief. But if a taxpayer would receive more favorable treatment under one or more of the factors provided in Rev. Proc. 2003-61 and so advises the IRS, the IRS will apply those factors from Rev. Proc. 2003-61, until the new revenue procedure is finalized.

a. The Tax Court tells the IRS that even if it wants to make a taxpayer favorable change to a Revenue Procedure, it needs to finalize it, not just publish a proposed Revenue Procedure. Deihl v. Commissioner, T.C. Memo. 2012-176 (6/21/12). The Tax Court (Judge Marvel) declined to apply the provisions of the proposed revenue procedure set forth in Notice 2012-8, 2012-4 I.R.B. 309, in determining whether the taxpayer was entitled to equitable relief under § 6015(f) and instead applied Rev. Proc. 2003-61, 2003-2 C.B. 296, "in view of the fact that the proposed revenue procedure is not final and because the comment period under the notice only recently closed." It did however note "where appropriate how the analysis used in Rev. Proc. 2003-61 . . . would change if the proposed revenue procedure in Notice 2012-8 . . . had actually been finalized." But on the facts the proposed changes did not affect the conclusion that relief was not warranted.

2. APA, schmay PA! The Tax Court's review of § 6015(f) relief denial is de novo and new evidence is admissible. Wilson v. Commissioner, 705 F.3d 980 (9th Cir. 1/15/13). The Ninth Circuit in a divided opinion (2-1) by Judge Thomas, held that, in reviewing the IRS's denial of § 6015 innocent spouse relief, the Tax Court properly considered new evidence outside the administrative record and correctly applied a de novo standard of review in determining the taxpayer's eligibility for § 6015(f) equitable relief. The court reasoned as follows:

> Section 6015(e)'s jurisdictional grant to determine whether equitable relief is warranted in a § 6015(f) case must be read alongside subsection (f)'s mandate to consider the totality of the circumstances before making an equitable relief determination. "Taking into account all the facts and circumstances" is not possible if the Tax Court can review only the evidence available at the time of the Commissioner's prior determination.

- The majority also rejected the IRS's argument that the Administrative Procedure Act applied to limit the Tax Court's review. The court reasoned that the "extensive legislative history of [§§ 6015(e) and (f)] demonstrates that the special procedures enacted by Congress displace application of the APA in innocent spouse tax relief cases, and the APA does not apply." The court emphasized that at no time before the Tax Court proceeding is there a formal administrative at which the taxpayer can present the case before an administrative law judge; at no time during the administrative process is the taxpayer afforded the right to conduct discovery, present live testimony under oath, subpoena witnesses for trial, or conduct cross-examination. These procedures are available only in the Tax Court. Finally, the Ninth Circuit acknowledged that "a de novo scope of evidentiary review is incompatible with an abuse of discretion standard," but concluded that "the nature of equitable relief ... favors de novo review."

> The Tax Court must be able to compile a de novo record if it is to consider "all the facts and circumstances" when deciding whether a taxpayer is entitled to relief from joint liability under § 6015(f), but it is pointless to do so if it can only review the Commissioner's denial of equitable relief for an abuse of discretion. The only way for the Tax Court to proceed de novo when hearing petitions for relief under § 6015(f) is by applying both a de novo standard and scope of review.

- Accordingly, the Ninth Circuit affirmed the Tax Court's decision granting relief.

- Judge Bybee dissented, arguing that the Administrative Procedure Act applied, and the Tax Court as a reviewing court is limited to the administrative record and a review for abuse of discretion by the IRS.

- In *Commissioner v. Neal*, 557 F.3d 1262 (11th Cir. 2009), the Eleventh Circuit, the only other circuit that has considered the scope of the Tax Court's review in § 6015(f) cases, reached the same conclusion as the Ninth Circuit majority.

3. The significant benefit of getting to own your home free and clear of a mortgage lien precludes equitable relief. Haggerty v. Commissioner, 111 A.F.T.R.2d 2013-411 (5th Cir. 1/3/13). The taxpayer sought § 6015(f) equitable relief for taxes due with respect to her late husband's premature IRA withdrawal that was reported on their joint return for the year of his death. She had no knowledge of the withdrawal and the use of the funds to pay off a second mortgage lien on their home, which as a result of his death she owned outright, until after her husband's death. In a per curiam opinion, the Fifth Circuit upheld denial of relief. Because the taxpayer signed and filed the return after her husband's death and the income tax liability was properly reported but not paid, she knew that her husband would not pay the tax liability. The key to the holding, however, was that the taxpayer received a significant economic benefit when her husband paid off the second mortgage against their home.

H. Miscellaneous

1. The whistleblower made no noise, and kept his (?) identity secret. Whistleblower 14106-10W v. Commissioner, 137 T.C. No. 15 (12/8/11). In a reviewed opinion by Judge Thornton, the Tax Court granted summary judgment for the IRS in this case in which a whistleblower appealed the IRS's denial of a reward. The IRS filed the affidavit of a Chief Counsel Attorney "declaring, on the basis of his review of respondent's administrative and legal files and on the basis of conversations with relevant IRS personnel, that the information petitioner provided resulted in respondent's taking no administrative or judicial action against X or collecting from X any amounts of tax, interest, or penalty," and the whistleblower did "not set forth, by affidavits or otherwise, any specific facts showing that there [was] a genuine issue for trial." The court granted the whistleblower's request for anonymity and redaction from the record of any identifying information because the potential harm from disclosing the whistleblower's identity as a confidential informant outweighed the public interest in knowing the whistleblower's identity in a case decided on summary judgment for the IRS denying an award. Because granting the request for anonymity and redaction adequately protected the whistleblower's privacy interests as a confidential informant, the motion to seal the record was denied.

a. Calculating collected proceeds in calculating whistleblower awards. T.D. 9580, Rewards and Awards for Information Relating to Violations of Internal Revenue Laws, 77 F.R. 10370 (2/22/12). The Treasury Department promulgated final regulations relating to the payment of rewards under § 7623(a) for detecting underpayments or violations of the internal revenue laws and whistleblower awards under § 7623(b) that amend Reg. § 301.7623-1. The amendments clarify the definitions of proceeds of amounts collected and collected proceeds and provide that the provisions of Reg. § 301.7623-1(a) concerning refund prevention claims are applicable to claims under § 7623(a) and (b). "[B]oth proceeds of amounts collected and collected proceeds include: Tax, penalties, interest, additions to tax, and additional amounts collected by reason of the information provided; amounts collected prior to receipt of the information if the information provided results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided."

b. You could be the next one to strike it rich by ratting out your employer. IRS Summary Award Report, 9/11/12. The IRS Whistleblower Office recommended a payment of $104 million to former UBS banker Bradley Birkenfeld based on his 2009 claim under § 7623(b). The non-redacted portion of the recommendation read:

> Birkenfeld provided information on taxpayer behavior that the IRS had been unable to detect, provided exceptional cooperation, identified connections between parties to transactions (and the methods used by UBS AG), and the information led to substantial changes in UBS AG business practices and commitment to future compliance. The actions against UBS AG and the attendant publicity also contributed to other compliance programs. Each of these factors could support an increase in the award percentage above the statutory minimum. The comprehensive information provided by the whistleblower was exceptional in both its breadth and depth. While the IRS was aware of tax compliance issues related to secret bank accounts in Switzerland and elsewhere, the information provided by the whistleblower formed the basis for unprecedented actions against UBS AG, with collateral impact on other enforcement activities and a continuing impact on future compliance by UBS AG.

c. No relief for an uncompensated whistleblower when the IRS closes its ears to the whistle. Cohen v. Commissioner, 139 T.C. No. 12 (10/9/12). In a case of first impression, the Tax Court (Judge Kroupa) held that no relief is available to a whistleblower under § 7623(b) when the IRS denies a claim without initiating an administrative or judicial action or collecting proceeds. The taxpayer's argument that the IRS abused its discretion by not acting on his information was rejected.

d. More comprehensive Proposed Regulations on how to get rich ratting out tax cheats. REG–141066–09, Awards for Information Relating to Detecting Underpayments of Tax or Violations of the Internal Revenue Laws, 77 F.R. 74798 (12/18/12). The Treasury Department has published detailed comprehensive proposed regulations regarding whistleblower awards under section § 7623 to replace the current final regulations that are only slightly more than one year old. The proposed regulations provide guidance on eligibility and submitting information to the IRS and filing claims for award with the Whistleblower Office that are intended to clarify the process individuals should follow to be eligible to receive whistleblower awards; the proposed regulations in large part, track the existing regulations. A claimant must provide the name of the taxpayer and specific facts and documents to support the claim. The proposed regulations reaffirm the practice of Treasury and the IRS to safeguard the identity of whistleblowers whenever possible. The definitions of proceeds of amounts collected and collected proceeds in the proposed regulations build on the definitions in the existing regulations, but some definitions, such as "related actions," are new. The definition of "collected proceeds" restates the rule from those final regulations that collected proceeds include: tax, penalties, interest, additions to tax, and additional amounts collected because of the information provided; amounts collected prior to receipt of the information provided if the information results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided. Prop. Reg. § 301.7623–3 describes the administrative proceedings applicable to claims whistleblower awards. Prop. Reg. § 301.7623-4 provides the framework and criteria that the Whistleblower Office will use in exercising its discretion to make awards. The proposed regulations are consistent with, and build on, the award determination provisions provided in the Internal Revenue Manual. The proposed regulations will be effective upon finalization.

2. IRS provides "Fresh Start" penalty relief for the faltering self-employed and the unemployed. IR-2012-31 (3/7/12). Relief for the failure-to-pay penalty of 0.5 percent per month (up to a maximum of 25 percent) is provided for otherwise compliant taxpayers who are either wage earners who have been unemployed for at least 30 days during 2011 and 2012 (up to the 4/17/12 filing deadline) or self-employed people who experienced a 25 percent or greater reduction in business income due to the economy. The announcement also doubles the dollar threshold for tax balance due amount that qualifies for the streamlined installment agreement program from $25,000 to $50,000 and raises the term for such agreements from five years to six years; these programs can be set up on the IRS website without the filing of Form 433-A or Form 433-F financial statements.

a. The IRS announces more flexible offer-in-compromise terms. IR-2012-53 (5/21/12). The IRS announced an expansion of its "Fresh Start" initiative that would enable taxpayers to revise their tax problems in as little as two years (compared to the four or five years in the past). The changes include: (1) revising the calculation for the taxpayer's future income; (2) allowing taxpayers to repay their student loans; (3) allowing taxpayers to pay state and local delinquent taxes; and (4) expanding the Allowable Living Expense allowance category and amount.

3. A zero return is a nothing. Waltner v. United States, 679 F.3d 1329 (Fed. Cir. 4/19/12). The Federal Circuit (Judge Prost) held that amended returns showing zeros for all income items and income taxes withheld were not a valid tax returns, and hence not valid administrative refund claims. Thus there was no jurisdiction to hear a refund suit.

4. The Constitution does not require Appeals Officers for CDP hearings to be appointed by the President. Tucker v. Commissioner, 676 F.3d 1129 (D.C. Cir. 4/20/12), *aff'g* 135 T.C. 114 (7/26/10). The taxpayer requested a CDP hearing after the IRS issued a notice of filing of a tax lien. After the settlement officer had upheld the tax lien notice, the taxpayer requested a remand for a hearing to be heard by an officer appointed by the President or the Secretary of the Treasury, in compliance with the Appointments Clause of U.S. Const., art. II, sec. 2, cl. 2. The Tax Court (Judge Gustafson) held that an "officer or employee" or an "appeals officer" under § 6320 or § 6330 is not an "inferior Officer of the United States" for purposes of the Appointments Clause. They are instead properly hired, pursuant to § 7804(a), under the authority of the Commissioner of Internal Revenue. The taxpayer's motion to remand was denied. In an opinion by Judge Williams, the Court of Appeals for the District of Columbia affirmed the Tax Court's decision. "[T]o be an 'Officer of the United States' covered by Article II, a person must 'exercis[e] significant authority pursuant to the laws of the United States.'" However, "Appeals employees' discretion is highly constrained. . . . [T]he significance and discretion involved in the decisions seem well below the level necessary to require an 'Officer.'"

5. Just as a taxpayer is not required to file an amended return, the IRS is not required to accept and process an amended return. Roberts v. Commissioner, T.C. Memo. 2012-144

(5/21/12). The taxpayer filed a return for 2007 reporting zero taxable income and $6,000 of withheld taxes. The IRS processed the return and applied the $6,000 overpayment to the taxpayer's unpaid 1983 tax liability. Subsequently, the taxpayer filed an amended return for 2007 reporting nearly $59,000 of taxable income, but the IRS did not process the amended return. Instead the IRS sent a deficiency notice with respect to the same amounts reported on the amended return, and did not credit the $6,000 withholding against the 2007 taxes. The taxpayer argued that was improper for the IRS to apply the overpayment claimed on his original 2007 return to a prior year tax liability, but the Tax Court (Judge Foley) was unimpressed by the argument.

> Petitioner further contends that respondent was required to treat his amended 2007 return as superseding the original 2007 return. We disagree. Taxpayers are permitted to submit amended returns, but the Commissioner is "not statutorily required to *** [accept an amended return], or to treat an amended return as superseding an original return." Fayeghi v. Commissioner, 211 F.3d 504, 507 (9th Cir. 2000), aff'g T.C. Memo. 1998-297.

6. You can remove those mindless disclaimers from your emails when these proposed regulations become final (but not before).[8] REG-13867-06, Regulations Governing Practice

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[8] Chicago lawyer Sheldon I. Banoff suggests consideration of the following language at the end of emails until the proposed regulations become final:

> CIRCULAR 230 DISCLOSURE, NON-DISCLOSURE AND DISCLOSURE OF NON-DISCLOSURE: In accordance with Treasury Regulations Circular 230, any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter addressed herein (together, the "Prohibited Purposes"). In September 2012 Treasury proposed elimination of the requirement of the aforementioned Circular 230 disclosure, to be effective prospectively only (upon adoption in final form and publication of the revised Circular 230 in the Federal Register). Until that time, our emails shall continue to include the aforementioned Circular 230 disclosure. At such time as we are no longer required to include the aforementioned Circular 230 disclosure, we shall no longer do so; however, we recognize that those handful of you who previously have bothered to read our Circular 230 disclosure will at that time wonder whether the elimination of our Circular 230 disclosure was due to oversight or, worse yet, that the email being sent by us to you <u>is</u> in fact "intended or written to be used," and <u>can</u> be used, for the Prohibited Purposes. Such inference is not intended (except in those extremely rare cases where it <u>is</u> intended, i.e., where you really <u>would be</u> entitled to so use our emails for the Prohibited Purposes). Therefore, effective as of the moment that the revised Treasury Regulations Circular 230 is published in the Federal Register, which should only happen in our lifetimes, the following disclosure shall become operative without any further action on our part: "Treasury Regulations Circular 230 was recently amended to eliminate the requirement that we disclose to you that any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter addressed herein (the "Prohibited Purposes"). Therefore, as of this moment you should not consider this email to be a Circular 230 disclosure. However, no inference is intended, and none should be taken, that our failure to make a Circular 230 disclosure to you from this moment forward shall entitle you to rely on any tax advice herein for any Prohibited Purpose. Further, in the event any person who is a member of,

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Before the Internal Revenue Service, 77 F.R. 57055 (9/17/12). In the course of a comprehensive revision of the requirements for tax opinions, these proposed Circular 230 regulations include the following:

- The rigid covered opinion rules in current § 10.35 (which require that the written opinion contain a description of the relevant facts, the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts) are removed; these rules are replaced with a single standard for all written tax advice under proposed § 10.37. This standard requires that the practitioner must: (i) base the written advice on reasonable factual and legal assumptions; (ii) reasonably consider all the relevant facts that the practitioner knows or should know; (iii) use reasonable efforts to identify and ascertain the facts relevant on each Federal tax matter; (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable; and (v) not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. The determination of whether a practitioner has failed to comply with these requirements is based on all the facts and circumstances, not on whether each requirement is addressed in the written advice.

- Proposed § 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS (including providing written opinions), which includes the required knowledge, skill, thoroughness, and preparation necessary for the matter for which he is engaged. This complements the provision in § 10.51 that a practitioner can be sanctioned for incompetent conduct.

- Proposed § 10.36 conforms the "procedures to ensure compliance" with the removal of the covered opinion rules in current § 10.35, but expands these "procedures to ensure compliance" to include all of the provisions of Circular 230.

- Proposed § 10.1 provides that the Office of Professional Responsibility – as opposed to the IRS Return Preparer Office – would have exclusive responsibility for matters related to practitioner discipline.

- Proposed § 10.82 extends the expedited disciplinary procedures for immediate suspension, but limits it to practitioners who have engaged in a pattern of willful disreputable conduct by failing to make an annual Federal tax return during four of five tax years immediately before the institution of the expedited suspension proceeding, provided that the practitioner is also noncompliant at the time the notice of suspension is served.

- Proposed § 10.31 forbids practitioners from negotiating any taxpayer refunds, which specifically adds manipulation of any electronic refund process.

7. **Not just any old express mail service cuts the mustard when you wait until the last minute to file a Tax Court petition.** Scaggs v. Commissioner, T.C. Memo. 2012-258 (9/10/12). Tax Court Special Trial Judge Armen held that a Tax Court petition received more than 90 days after the date of a deficiency notice but which was sent via FedEx "Express Saver Third business day" within the 90-day period, was not timely filed. Notice 2004–83, 2004–2 C.B. 1030, which lists the private delivery serves

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employed by or affiliated with this firm should continue to include a Circular 230 disclaimer on any email after the amendment of Circular 230 becomes effective, no negative inference should be taken that the emails of any others who are members of, employed by or affiliated with our firm whose emails do not contain the Circular 230 disclosure but which contain any tax advice can be used for the Prohibited Purposes, without the express written consent of an authorized representative of the firm.

that qualify for the same "mailbox" treatment as shipment via the U.S. Postal Service pursuant to § 7502(f), does not list FedEx "Express Saver Third business day."

8. If the statute requires Appeals to consult with Chief Counsel, it's not a prohibited *ex parte* communication. Hinerfeld v. Commissioner, 139 T.C. No. 10 (9/27/12). The taxpayer's proposed offer in compromise was rejected and he sought review in the Tax Court. Among the taxpayer's arguments was that the Appeals Officer had an improper ex parte consultation with Chief Counsel's Office, violating the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. at 689, and Rev. Proc. 2000-43, 2000-2 C.B. 404, which provides guidelines in question and answer format that are designed to distinguish prohibited and permissible ex parte communications between Appeals and other IRS employees during an administrative appeal. The Tax Court (Judge Gale) rejected the taxpayer's argument. The Appeals Officer had consulted Chief Counsel's Office to seek an opinion as to whether the taxpayer had made a fraudulent conveyance. There was no evidence of improper communications, and review by Counsel was mandated by § 7122(b), which, when the IRS is to compromise any unpaid tax assessed of $50,000 or more, requires an opinion of the Chief Counsel to be filed with the IRS.

9. The IRS can't disclose knowingly false taxpayer information just because it could have disclosed true information. Aloe Vera of America, Inc. v. United States, 699 F.3d 1153 (9th Cir. 11/15/12). The statute of limitations under § 7431(d) on a claim for wrongful disclosure of a tax return begins to run when the taxpayer knows or reasonably should know of the government's allegedly unauthorized disclosures. On the facts of the case, the statute of limitations did not begin to run when the taxpayer became aware of a pending general investigation that would involve disclosures, but only later when they knew or should have known of the specific disclosures at issue. Under § 6103(k)(4), return information may be disclosed to a foreign government that has a tax treaty with the United States, if such information as is pertinent to carrying out the provisions of the treaty or preventing fraud or fiscal evasion in relation to the taxes which are the subject of the treaty. But the disclosure of knowingly false information to a foreign tax authority in a proposal for a simultaneous tax examination is not protected as "pertinent" information. There was a genuine issue of material fact as to whether the government knowingly disclosed false information, and the District Court's grant of summary judgment for the government was vacated and the issue remanded.

10. Prison tax returns. The 2012 Taxpayer Relief Act, § 209, expands the list of persons to whom false prisoner tax returns may be disclosed by the IRS under Code § 6103(k)(10) to include officers and employees of the Federal Bureau of Prisons, state agencies charged with prison administration, and contractors responsible for operating a Federal or state prison.

11. This case is just like *Loving v. Virginia*, 388 U.S. 1 (1967), except that, instead of freeing interracial same sex couples from discriminatory marriage laws, it is about freeing marginal tax return preparers from discriminatory competence testing. Loving v. IRS, 111 A.F.T.R.2d 2013-589 (D.D.C. 1/18/13). The District Court (Obama appointee Judge Boasberg) enjoined the IRS from regulating otherwise unregulated "tax-return preparers" because they are not "representatives" and do not "practice" before the IRS and are not covered under 31 U.S.C. § 330(a) (authorizing the regulation of "the practice of representatives of persons before the [IRS]"). The regulation of tax-return preparers under Circular 230, including registration, payment of fees, passing a qualifying exam, and completing continuing education courses annually, fails the *Chevron* step one test because preparation of tax returns does not require that a "representative demonstrate … (D) competency to advise and assist persons in presenting their cases," 31 U.S.C. § 330(a)(2)(D), on the ground that "[a]t the time of filing the taxpayer has no dispute with the IRS; there is no 'case' to present." Judge Boasberg also noted that the "unstructured independence by the IRS [under Circular 230] would trample *the specific and tightly controlled penalty scheme in Title 26*" (emphasis added).

- Note that there is neither privilege nor work product protection for communications to a tax return preparer, which arises only when there is a realistic possibility of "controversy."

a. The injunction is modified, but not stayed. Loving v. IRS, 111 A.F.T.R.2d 2013-702 (D.D.C. 2/1/13). On the IRS's motion to stay the injunction, Judge Boasberg – while refusing to stay the injunction – modified it to make clear that its requirements were less burdensome than the IRS claimed. The requirement that each tax return preparer obtain a PTIN (and pay related fees) is authorized under § 6109(a)(4), so it may continue, except that the "IRS may no longer condition PTIN eligibility on being 'authorized to practice' under 31 U.S.C. section 330." Therefore, "the requirements that tax return preparers (who are not attorneys, CPAs, enrolled agents, or enrolled actuaries) must pay fees unrelated to the PTIN, pass a qualifying exam, and complete annual continuing-education requirements" continue to be enjoined.

b. Government's motion for a stay pending appeal was denied summarily. Loving v. IRS, __ (D.C. Cir. 3/27/13) (Rogers, Tatel, and Brown, JJ, per curiam) (unpublished). The IRS appealed these two opinions and orders to the Circuit Court for the District of Columbia Circuit, 2/20/13. That court refused to stay the District Court's injunction on the ground that the IRS failed to satisfy "the stringent requirements for a stay pending appeal."

12. Ryan loses its constitutional challenge to Circular 230's contingent fee rule. Ryan, LLC v. Lew, 2013 U.S. Dist. LEXIS 45430 (D. D.C. 3/29/13). Plaintiffs challenge § 10.27 of Circular 230 that generally limits the use of contingent fee arrangements in connection with the preparation and filing of refund claims with the IRS. More specifically, they mounted three distinct attacks against Circular 230: (1) Ryan, LLC and Mr. Ryan argued that Circular 230 violates their rights under the Petition Clause of the First Amendment (Count I); (2) Mr. Ryan argued that Circular 230 violates his Fifth Amendment Due Process Rights (Count II); and (3) Mr. Ridgely brought suit under the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701, *et seq.*, arguing that the IRS exceeded its statutory authority in promulgating Circular 230 (Count III). Plaintiffs sought a declaratory judgment that Circular 230's restrictions of contingent fee arrangements in the context of "ordinary refund claims" is unconstitutional and exceeds the scope of the IRS's authorizing statute, and they sought a permanent injunction barring the enforcement of Circular 230's restrictions on the use of contingent fee arrangements for "ordinary refund claims." The District Court (Judge Wilkins) dismissed Counts I and II on the grounds that: Count I failed to state a claim upon which relief may be granted, and Mr. Ryan lacked standing under Count II to pursue a Due Process claim so that claim lacked jurisdiction.

- With respect to an issue he didn't address, Judge Wilkins stated:

> In pressing for the dismissal of Plaintiffs' claim, the Government first argues that the Petition Clause does not protect "a taxpayer's right to file an administrative claim for refund" with the IRS. (Defs.' Reply at 7). The Court finds this proposition dubious. Not only has the Supreme Court explicitly held that Petition Clause guarantees citizens the ability to seek relief with courts, but it has also made clear that these protections extend to "other forums established by the government for the resolution of legal disputes." *Borough of Duryea*, 131 S. Ct. at 2494. The Court has also explained that "[t]he same philosophy governs the approach of citizens or groups of them to administrative agencies (which are both creatures of the legislature, and arms of the executive) and to courts, the third branch of Government." *Cal. Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508, 510 (1972) ("Certainly the right to petition extends to all departments of the Government. The right of access to the courts is indeed but one aspect of the right of petition."). Insofar as the Internal Revenue Service is an administrative agency established by the Government, the Court believes that the

Petition Clause would protect citizens' rights to file claims with the IRS, as Plaintiffs suggest. On balance, however, the Court need not directly pass on this issue because, even assuming that the right to file a refund claim with the IRS does fall within the ambit of the Petition Clause's protections, Plaintiffs fail to allege any constitutionally cognizable violation or impingement of such a right.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Full-time resident horse farm workers don't have enough independence from the horse-mistress. Twin Rivers Farm, Inc. v. Commissioner, T.C. Memo. 2012-184 (7/2/12). The Tax Court (Judge Ruwe) denied the subchapter S corporation's petition for redetermination of the IRS's determination of employment status for two farm workers on the taxpayer's Tennessee horse farm. In spite of assertions by the taxpayer's sole shareholder that she did not exercise control over the two workers, the court noted that to maintain the requisite degree of control to establish employee status the principal need not directly control the worker; it is sufficient that the principal has the right to do so. The court indicated that by the nature of the work relationship, it was likely that the shareholder had the right to exercise control. The workers were using the taxpayer's equipment, caring for the corporation's principal assets, and living full time in a trailer on the taxpayer's property. The court pointed out that if the workers were not exercising their duties appropriately that the shareholder would certainly have intervened with direction. The court also pointed to the fact that the workers were receiving a regular weekly salary for their services and were long-term employees who resided on the farm. In addition, the taxpayer maintained workers compensation insurance and covered the workers' necessary job-related expenditures. The court also held the taxpayer liable for penalties under § 6651(a)(1) for failure to file the required Form 943 for employers of agricultural workers and penalties under § 6656 for failure to make timely employment tax deposits.

2. Skilled pieceworkers were employees even though the employer did not "stand over them" to control them. Atlantic Coast Masonry, Inc. v. Commissioner, T.C. Memo 2012-233 (8/13/12). In spite of the fact that construction masons and laborers were paid in cash by the taxpayer on a piece-work basis, the workers were held to be employees by Judge Jacobs. The Tax Court noted that the workers were skilled craftsmen who did not require direct supervision. Nonetheless, instruction from the taxpayer on the nature of the work and requirements for completion constituted control over the workers. "An employer need not 'stand over' the employee to control an employee." The court also indicated that the workers did not share in profits and losses notwithstanding the piece-work nature of the workers' compensation, and that the factor supported employee status. Section 530 relief was denied because the taxpayer failed to file Forms 1099 with respect to the workers. The taxpayer was also held liable for § 6651 penalties for failure to file required employment tax returns and § 6656 penalties for failure to pay required employment tax deposits. The court held that the taxpayer failed to demonstrate reasonable cause for the absence of filings.

3. Tax refunds in a bad economy set up another deference conflict among the circuits. In Re Quality Stores, Inc., 693 F.3d 605 (6th Cir. 9/7/12). In November 2001 Quality Stores closed 63 stores and 9 distribution centers and terminated the employment of all employees in the course of Chapter 11 bankruptcy cases. Quality Stores adopted plans providing severance pay to terminated employees. The company reported the severance pay as wages for withholding and employment tax purposes then filed claims for refund of FICA and FUTA taxes claiming that the severance pay represented supplemental unemployment compensation benefits (SUBs) that are not wages for employment tax purposes. Disagreeing with the contrary holding by the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), the Sixth Circuit held that the SUBs were exempt from employment taxes. The court examined the language and legislative history of § 3402(o)(1), which provides that SUB payments "shall be treated *as if it were a payment of wages*" for withholding purposes, to conclude that by treating SUB payments as wages for withholding, Congress recognized that SUB payments were not otherwise subject to withholding because they did not constitute "wages." Then, under *Rowan Cos. v. United States*, 452 U.S. 247, 255 (1981), the court concluded that the term "wages" must carry the same meaning for withholding and employment tax purposes. Thus, if SUBs are not wages under the withholding provision (because the must be treated as wages by statutory directive), the SUBs are not wages for employment tax purposes. The court also rejected the IRS's position in Rev. Rul. 90-72, 1990-2 C.B. 211, that to be excluded from employment taxes SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit's holding in *CSX Corp.*, which adopted the eight part test of Rev. Rul. 90-72, stating that, "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories." The court also stated that it could not conclude that the opinion in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), eroded the holding of *Rowan Cos. v. United States*, which compelled the court to interpret the meaning of "wages" the same for withholding and employment tax purposes.

- Will the disagreement between the Federal and Sixth Circuits once again invite the Supreme Court to enter the deference fray?

4. The District Court for the Eastern District of New York gets the message. Recoveries in age discrimination suit are wages. Gerstenbluth v. Credit Suisse Securities (USA) LLC, 110 A.F.T.R.2d 2012-6238 (E.D. N.Y. 9/28/12). The District Court for the Eastern District of New York (Judge Seybert) granted summary judgment to defendants in a claim for refund against the employer and the IRS for employment taxes withheld by the employer on damages paid to the taxpayer in a successful claim for age discrimination. The court ruled that money paid to settle employment discrimination claims constitute wages where the money represents back pay or front pay. Although the settlement agreement with Credit Suisse did not explicitly describe the payment as wages, the court concluded that the payment represented wages based on the employer's characterization of the payment as wages in reporting the settlement as compensation on Form W-2.

a. As does the Northern District. Back and front pay in a Title VII wrongful discharge recovery are wages. Noel v. New York State Office of Mental Health Central New York Psychiatric Center, 697 F.3d 209 (2d Cir. 8/31/12). The plaintiff in a Title VII wrongful discharge case recovered damages for back and front pay in a jury trial. The State Office of the Controller withheld employment taxes from its payment of the judgment. The District Court for the Northern District of New York ordered the Controller to pay the full amount of the judgment. In an appeal filed by the Controller, joined by the Tax Division of the Justice Department as *amicus*, the Court of Appeals held that the front and back pay constituted wages subject to withholding. The court noted that both front and back pay constitute remuneration paid to compensate for what the employee would have earned had the employee not been a victim of discrimination. Thus, the court concluded that, "[t]hese amounts are 'wages' because they constitute 'remuneration' for services during an employee-employer relationship."

5. Funding health care by making the HI tax more progressive. Section 1401, as amended by the 2010 Health Care Act, increases the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages in excess of a threshold amount. The threshold amount is $250,000 of the combined wages of both spouses on a joint return ($125,000 for a married individual filing a separate return). The threshold is $200,000 for all other individuals. The employer must withhold the additional HI tax, but in determining the employer's withholding requirement and liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account, and the employer disregards the employee's spouse's wages. I.R.C. § 3102(f). The employee is liable for the additional 0.9 percent HI tax to the extent the tax is not withheld by the employer. Section 1402(b), as amended, imposes an additional tax of 0.9 percent on self-employment income above the same thresholds. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the FICA tax with respect to the taxpayer. No deduction under § 164(f) is allowed for the additional SECA tax, and the alternative deduction under § 1402(a)(12) is determined without regard to the additional SECA tax rate. The additional tax applies to wages received in taxable years after 12/31/12.

a. Proposed regulations relating to the Additional Medicare Tax. REG-130074-11, Rules Relating to Additional Medicare Tax, 77 F.R. 72268 (12/5/12). Proposed regulations under §§ 1401, 3101 and 3102, relating to Additional Hospital Insurance Tax on income above threshold amounts ("Additional Medicare Tax"), as added by the Affordable Care Act. Specifically, these proposed regulations provide guidance for employers and individuals relating to the implementation of Additional Medicare Tax. This document also contains proposed regulations relating to the requirement to file a return reporting Additional Medicare Tax, the employer process for making adjustments of underpayments and overpayments of Additional Medicare Tax, and the employer and employee processes for filing a claim for refund for an overpayment of Additional Medicare Tax.

- The changes to §§ 1401 and 3102 are effective for tax years beginning after 12/31/12, and taxpayers may rely on the proposed regulations for purposes of complying with these section until the effective date of the final regulations, which are expected to be made final during 2013 and will be applicable to tax years beginning after 12/31/13.

- FAQs to the Additional Medicare tax were released by the IRS on 11/30/12, 2012-TNT 232-48.

6. Proposed regulations define employment tax liabilities of agents designated by an employer to pay employment taxes. Reg-102966-10. Designation of Payor as Agent to Perform Acts Required of an Employer, 78 F.R. 6056 (1/29/13). Proposed regulations under § 3405 would provide rules regarding obligations for all employment tax under an agreement between an employer and a third party payor that is designated as an agent to perform the acts of the employer. The proposed regulations would provide that all provisions of the law, including penalties are applicable to the payor, and that the employer for which the payor is designated as agent also remains liable for all provisions of the employment tax. The preamble indicates that consistent with the IRS position on administering the § 6672 trust fund penalty, the employment tax liability of an employer will be collected only once whether from the payor or the employer. The agency designation does not apply to (1) a payor that is itself the common law employer of a person performing services for a client, (2) a payor that has legal control over the payment of wages under § 3401(d)(1) (and is thus the liable employer), and (2) a payor who is a payroll service provider that reports employment taxes under the employer's EIN.

B. Self-employment Taxes

1. Good preaching at home does not avoid self-employment tax for this carpenter. Good v. Commissioner, T.C. Memo 2012-323 (11/20/12). The taxpayer's claimed ministry for Prepare the Way Ministries, formed based on various books about churches and taxes, did not exempt the taxpayer's income from various services from self-employment tax under the minister exception of § 1402(c)(4). Taxpayer's receipts were also otherwise includible in gross income. The Tax Court (Judge Marvel) concluded that the taxpayer failed to provide any credible evidence that he was a minister of a church and held the taxpayer liable for fraud penalties.

2. Local police officers working off-duty security jobs are independent contractors. Specks v. Commissioner, T.C. Memo. 2012-243 (12/11/12). The taxpayer, a Houston police officer, provided off-duty security services in uniform for private companies. The private companies reported the remuneration on Forms 1099. The Tax Court (Judge Kroupa) determined that the taxpayer was an independent contractor subject to self-employment tax. The private parties did not train, supply, or equip the taxpayer in performing the security service, which was performed on an at-will basis. The court concluded that the absence of evidence of control over the taxpayer was to be given greater weight over other factors indicating employee status.

- The court sustained § 6662(a) accuracy-related penalties and indicated that the taxpayer failed to establish under § 664(c) reasonable reliance on a return preparer who was a competent professional with significant expertise and provided all of the relevant information.

C. Excise Taxes

1. The price of a tan goes up even in disregard of the hazard from which the owner is protected. T.D. 9596, Disregarded Entities and the Indoor Tanning Services Excise Tax, 77 F.R. 37806 (6/25/12). Temp. and Prop. Reg. § 1.1361-4T(a)(8)(iii) adds the 10 percent excise tax on indoor tanning services of § 5000B is added to the list of excise taxes for which disregarded entities (QSub or single owner business entity) that are treated as separate entities.

2. Roll your own, inhale, and pay the tax. Section 100122 of the Transportation Act would amend Code § 5702(d) to add to the tobacco excise tax any person who for commercial purposes makes available to the consumer a machine that rolls cigarettes, cigars, or other tobacco products. Previously the tax only applied to manufacturers of cigarettes and cigars who actually rolled the product, but did not apply to consumers who rolled their own. This change would add to the tobacco excise tax establishments that provided access to commercial grade rolling equipment to consumers who purchased the tobacco and paper from the retailer and fed it into the machine provided by the retailer, obtaining cigarettes at much lower cost free of the excise tax.

3. The IRS rejects a (former) Court of Claims limitation on retroactive application of rulings. AOD 2012002 (9/12/12). The IRS announced its nonacquiescence in *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), which held that the IRS could not apply a changed position on an excise tax issue prospectively from the date of revocation to a taxpayer whose erroneous favorable ruling was revoked, but retroactively as to another taxpayer. The Court of Claims in *IBM* held that it was an abuse of discretion to treat two competitors differently with respect to excise taxes on the same type of equipment.

4. Final regulations for the Medical Device Excise Tax. T.D. 9604, Taxable Medical Devices, 77 F.R. 72924 (12/5/12). Final Reg. §§ 48.4191-1 and -2 provide guidance on the excise tax imposed on the sale of certain medical devices, enacted by the Health Care and Education Reconciliation Act of 2010 in conjunction with the Patient Protection and Affordable Care Act. They define "taxable medical device" and provide for the imposition of the tax at a 2.3 percent rate on manufacturers, producers and importers making sales of such devices.

- The tax is applicable to sales on and after 1/1/13.

a. Notice 2012-77, 2012-52 I.R.B. 781 (12/5/12). The IRS has provided guidance regarding the § 4191 excise tax imposed on the sale of certain medical devises by domestic and foreign manufactures. The notice spells out a methodology for determining a constructive sales price applicable to manufacturers who sell through multiple distribution channels. The notice also exempts the sale price of domestically produced connivance kits for practitioners who install the medical device. Foreign produced convenience kits are subject to the excise tax only to the extent of the value of included taxable medical devices.

- FAQs to the excise tax were released by the IRS on 12/6/12, 2012-

TNT 235-22.

XII. TAX LEGISLATION

A. Enacted

1. The **Patient Protection and Affordable Care Act** ("PPACA" – pronounced "pee-pac-a" or "Obamacare"), P.L.111-148, was signed by President Obama on 3/23/10, and H.R. 4872, the **Health Care and Education Reconciliation Act of 2010** ("2010 Health Care Act" or "2010 Reconciliation Act"), P.L. 111-152, was signed by President Obama on 3/30/10.

a. **The 2010 Health Care Act is constitutional, but the "penalty" is not a "tax."** Thomas More Law Center v. Obama, 651 F.3d 529 (6th Cir. 6/29/11) (2-1). The Sixth Circuit Court of Appeals, in an opinion by Judge Martin, upheld the constitutionality of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029. The majority opinion upheld the Act under the Commerce Clause. Judge Sutton's concurring opinion also concluded that the Act was constitutional under the Commerce Clause, but held that the Act was not an exercise of the taxing power – the penalty for not purchasing health insurance was not a tax. An opinion by Senior District Judge Graham, concurring in part and dissenting in part, also held that the Act was not an exercise of the taxing power but would have held the Act unconstitutional as beyond Congress's power to regulate commerce.

b. **But, on the other hand, the Eleventh Circuit holds that the individual mandate is unconstitutional.** Florida v. Department of Health & Human Services, 648 F.3d 1235 (11th Cir. 8/12/11) (2-1). The Eleventh Circuit held that Congress exceeded its authority by requiring Americans to buy coverage, but also ruled that the rest of the wide-ranging law could remain in effect. The case stems from a challenge by twenty-six states which had argued the individual mandate, set to go into effect in 2014, was unconstitutional because Congress could not force Americans to buy health insurance or face the prospect of a penalty. The majority stated:

> This economic mandate represents a wholly novel and potentially unbounded assertion of congressional authority: the ability to compel Americans to purchase an expensive health insurance product they have elected not to buy, and to make them re-purchase that insurance product every month for their entire lives.

c. **Does anyone really care what D.C. Circuit thinks when the issue is already up on certiorari?** Seven-Sky v. Holder, 661 F.3d 1 (D.C. Cir. 11/8/11). The Court of Appeals for the District of Columbia (2-1) upheld the constitutionality of the minimum essential health care coverage requirement of § 1501 of the 2010 Patient Protection and Affordable Health Care Act, codified at Code § 5000A as an exercise of Congress's power under the Commerce clause. The suit was not barred by the Anti-Injunction Act because the suit involved a penalty unconnected to a tax liability. Judge Kavanaugh dissented as to jurisdiction because he would have held that the AIA barred the suit.

d. When President Obama said that the "individual mandate" was not a tax, Justices Kennedy, Scalia, Thomas and Alito thought he was being serious, but the Chief Justice and Justices Ginsburg, Breyer, Sotomayor and Kagan knew that, as usual, he was just fooling with us. National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566 (6/28/12). On certiorari to the Eleventh Circuit, the Chief Justice delivered the opinion for the Court which held: (1) that the suit to declare the individual mandate unconstitutional was not barred by the Anti-Injunction Act because Congress indicated that it did not want it to be so barred (9-0); (2) that the individual mandate was unconstitutional as an exercise of congressional power under the Commerce Clause (5-4); and (3) that the individual mandate was valid as a tax – but not a direct tax – under the Taxing Clause (5-4). With respect to the Direct Tax Clause, the Chief Justice stated:

> A tax on going without health insurance does not fall within any recognized category of direct tax. It is not a capitation. Capitations are taxes paid by every person, "without regard to property, profession, *or any other circumstance*." *Hylton, supra*, at 175 (opinion of Chase, J.) (emphasis altered). The whole point of the shared responsibility payment is that it is triggered by specific circumstances — earning a certain amount of income but not obtaining health insurance. The payment is also plainly not a tax on the ownership of land or personal property. The shared responsibility payment is thus not a direct tax that must be apportioned among the several States.

- There was some more stuff about Congress lacking the power to force states to expand Medicaid upon pain of denial of all federal aid to states for Medicaid, which was decided 7-2.

2. The **Moving Ahead for Progress in the 21st Century Act** (the "Transportation Act"), P.L. 112-140, was signed by President Obama on 7/6/12. Section 100122 of the Transportation Act amends Code § 5702(d) to add to the tobacco excise tax any person who for commercial purposes makes available to the consumer a machine that rolls cigarettes, cigars, or other tobacco products.

3. The **American Jobs Act of 2011** was orally signed by President Obama on 9/8/11. It will reduce the unemployment rate to 4 percent, cause the oceans to recede and cure cancer. Lacking are a written bill (because the Congressional Budget Office perversely refuses to score speeches) and the trivial detail of congressional voting (rendered irrelevant by President Obama's multiple repetitions of the necessity of immediate passage of the yet-unwritten bill, which Congress perversely failed to do on 9/9/11).

a. His directing that this fiscal cliff bill be "signed" with an autopen, instead of signing it himself, confirms that Obama acted arrogantly throughout this entire process. The lion's share of the Act consists of so-called "Jimmy Johnson" provisions. The American Taxpayer Relief Act of 2012 ("the 2012 Taxpayer Relief (and not so grand compromise) Act" or "the Act"), P.L. 112-240, was "signed" by President Obama's autopen on 1/2/13.

- According to a White House Press Secretary statement, it "makes permanent the temporary rates on taxable income at or below $400,000 for individual filers and $450,000 for married individuals filing jointly; permanently indexes the Alternative Minimum Tax exemption amount to the Consumer Price Index; extends emergency unemployment compensation benefits and Federal funding for extended benefits for unemployed workers for one year; continues current law Medicare payment rates for physicians' services furnished through December 31, 2013; extends farm bill policies and programs through September 30, 2013; and provides a postponement of the Budget Control Act's sequester for two months."

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

For the State Bar of Texas Tax Section

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TRANSFEREE LIABILITY

Thompson & Knight Impact®

DBA Tax Section

March 4, 2013
Bob Probasco
Robert.Probasco@tklaw.com

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TRANSFEREE LIABILITY

- The basics of transferee liability
- Recent developments – cases involving midco transactions
- Key issues/questions

THE BASICS OF TRANSFEREE LIABILITY

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SOURCE OF LAW

- **Internal Revenue Code supplies procedural rules, §§ 6901 – 6905**
    - **Dates back to Section 280 of the Revenue Act of 1926**
- **Substantive liability is generally based on state law**

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IRC § 6901(a)

- **The "liability, at law or in equity, of a transferee of property" for income taxes, estate taxes, and gift taxes shall "be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred."**

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IRC § 6901(a), cont'd

- N/A to employment taxes, excise taxes, etc.
- Does not itself create or define the substantive transferee liability
  - "At law" generally refers to liabilities established by contract
  - "At equity" generally refers to liability under state fraudulent transfer laws, or the "trust fund" doctrine

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STATUTE OF LIMITATIONS

- **Normal limitations period, § 6901(c):**
  - **For an initial transferee, one year beyond the limitations period for assessment against transferor**
  - **For subsequent transferees, one year beyond the limitations period for assessment against preceding transferee**
  - **Cumulative extension limited to 3 years**
- **Can extend by agreement, § 6901(d)**
- **Mailing of a notice of liability suspends, § 6901(f)**

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BURDEN OF PROOF

- **In Tax Court, § 6902(a)**
  - **Transferor's liability for tax: Petitioner's burden to disprove**
  - **Whether the petitioner is a "transferee" under appropriate legal standard: Respondent's burden to prove**
- **In refund suits, some courts have held that the plaintiff must prove the absence of transferee liability**
  - ***Madonia*, 57 A.F.T.R.2d 570 (W.D.N.Y. 1985); *Van Benschoten*, 47 A.F.T.R.2d 5707 (S.D. Cal. 1959)**

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EXHAUSTION OF REMEDIES

- **The Tax Court requires that the IRS first exhaust all <u>reasonable</u> remedies against the transferor before proceeding against the transferee - *Gumm*, 93 T.C. 475, 480 (1989); *Kuckenberg*, 35 T.C. 473, 480 (1960); *Miller*, 42 T.C. 593, 599 (1964)**

- **In *Gumm*, the 9th Cir. suggested that the IRS can proceed administratively against the transferee rather than undergo protracted litigation against the transferor**

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ACCESS TO INFORMATION

- **IRS won’t share information about the transferor’s tax liability until it issues the transferee notice of deficiency – IRC § 6103**
- **After transferee files a petition in Tax Court, he can request the court to order production of relevant records of the transferor – IRC § 6902(b)**

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SUBSTANTIVE LIABILITY

- Model act, Uniform Fraudulent Transfer Act ("UFTA"), established in 1984
- Texas version is the Texas Uniform Fraudulent Transfer Act ("TUFTA"), Tex. Bus. & Com. Code §§ 24.001-24.012

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TUFTA KEY CONCEPTS

- **"Reasonably equivalent value" (REV), defined as "within the range of values for which the transferor would have sold the assets in an arm's length transaction" TUFTA § 24.004(d)**

- **Insolvency – when the sum of the debtor's debts is greater than all of its assets at a fair valuation, § 24.003(a)**

  - **Presumed insolvent if it does not generally pay its debts as they become due, § 24.003(b)**

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TUFTA KEY CONCEPTS, cont'd

- **"Claim" means "a right to payment or property, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, <u>contingent</u>, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured," § 24.002(3)**

- **"Debt" means "a liability on a claim," § 24.002(5)**

FOUR TYPES OF "FRAUDULENT TRANSFER"

- **Applicable to existing claims, or future claims arising within a reasonable time after the transfer**
  - **Actual fraud, TUFTA § 24.005(a)(1)**
  - **Risk of insolvency, § 24.005(a)(2)**
- **Applicable to existing claims only**
  - **Constructive fraud, or actual insolvency, § 24.006(a)**
  - **Insider fraud, § 24.006(b)**

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ACTUAL FRAUD

- **Transfer “with actual intent to hinder, delay, or defraud any creditor”**

- **Badges of fraud, TUFTA § 24.005(b)**
  - **Transfer to an insider**
  - **Debtor retained possession or control**
  - **Transfer was concealed**
  - **Transfer after debtor threated with suit**
  - **Transfer of substantially all of debtor’s assets**

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ACTUAL FRAUD, cont'd

- **Badges of fraud, continued**
  - **Debtor absconds**
  - **Debtor removed or concealed assets**
  - **Did not receive REV for property transferred**
  - **Debtor was insolvent or became insolvent shortly thereafter**
  - **Transfer shortly before or after substantial debt was incurred**
  - **Transfer of essential assets of the business to a lienor who transferred them to an insider**

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RISK OF INSOLVENCY

- Debtor didn’t receive REV for the transfer, and
- Debtor either
  - Was engaged in a business or transaction for which remaining assets were unreasonably small, or
  - Intended to incur (or transferee believed or reasonably should have believed the debtor would incur) debts beyond its ability to pay

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CONSTRUCTIVE FRAUD

- **Debtor didn’t receive REV for the property**
- **Debtor was already insolvent or became insolvent as a result of the transfer**

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INSIDER FRAUD

- Transfers to insiders, e.g., director, officer, or "person in control" of a corporation, if
  - Transfer was made to pay an existing debt to the insider,
  - Debtor was insolvent at the time, and
  - Insider had reasonable cause to know of the insolvency
- In effect, this prevents insiders from putting their claims before other creditors when the company is insolvent

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DEFENSES

- Transferee is not liable for the debtor's debts if he took the property in good faith and paid REV; TUFTA § 24.009(a)

- Insider fraud does not apply if, § 24.009(b)

  - Transfer was made in the ordinary course of business between the debtor and the insider,

  - Debtor obtained "new value" from the insider after transfer, or

  - Transfer was part of a good-faith effort to rehabilitate the debtor and the transfer secured additional value

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IRS REMEDIES

- **Collect directly by filing suit to recover the transferred property, TUFTA § 24.008 or Federal Debt Collection Procedures Act 28 U.S.C. § 3301, *et seq.***

- **If transfer was after assessment, levy/seize the property, as the federal tax lien attaches, IRC § 6323(a), (h)(6)**

- **Assert transferee liability administratively under IRC §§ 6901 – 6905**

  - **Can reach <u>any</u> property owned by the transferee**

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RECENT DEVELOPMENTS

"Bad facts make bad law"?

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RECENT DEVELOPMENTS

- Several high-profile cases involving midco transactions
- The taxpayers have won the majority of the cases, but not all
- In the process, there have been some clarifications of the law – both positive and negative for taxpayers
- Still developing, as several cases are currently on appeal

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BAD FACTS

- Abusive “midco transaction” tax shelters made their first appearance in the late 1990s and became widely known around 2001

- IRS first identified these as a “listed transaction” in 2001, and shortly thereafter identified transferee liability as a way to combat them

- An internal directive in 2006 focused IRS efforts on collecting from parties other than the midco, by transferee liability

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LISTED TRANSACTION

- **Current definition, Notice 2008-111**
  - **Target corporation owns (directly or indirectly) assets with built-in gain and insufficient tax benefits to completely eliminate the gain**
  - **At least 80%, vote or value, of the stock is disposed of within a 12-month period**
  - **At least 65% of the target corporations assets are sold within a year before or year after the stock sale**
  - **At least half of the "built-in tax" of the target "is purportedly offset or avoided or not paid"**

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AS A PRACTICAL MATTER

- The IRS doesn't pursue transferee liability in all cases meeting the standards of Notice 2008-111, and may pursue even if the case doesn't meet those standards

- Most often, it is asserted for midco transactions involving
  - Promoted transactions, with the sale of all stock and all assets
  - Tax avoidance by improper means

- Typical fact pattern for the recent cases:

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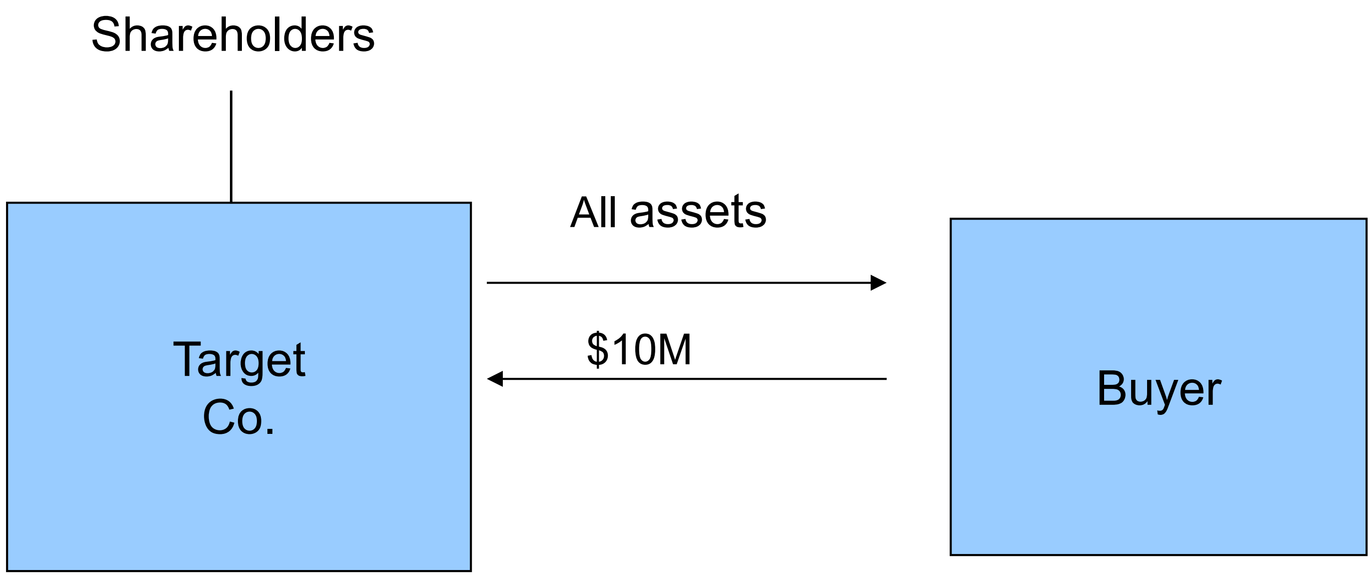
MIDCO TRANSACTION
STEP 1



Net assets -- basis of $2M, FMV of $10M

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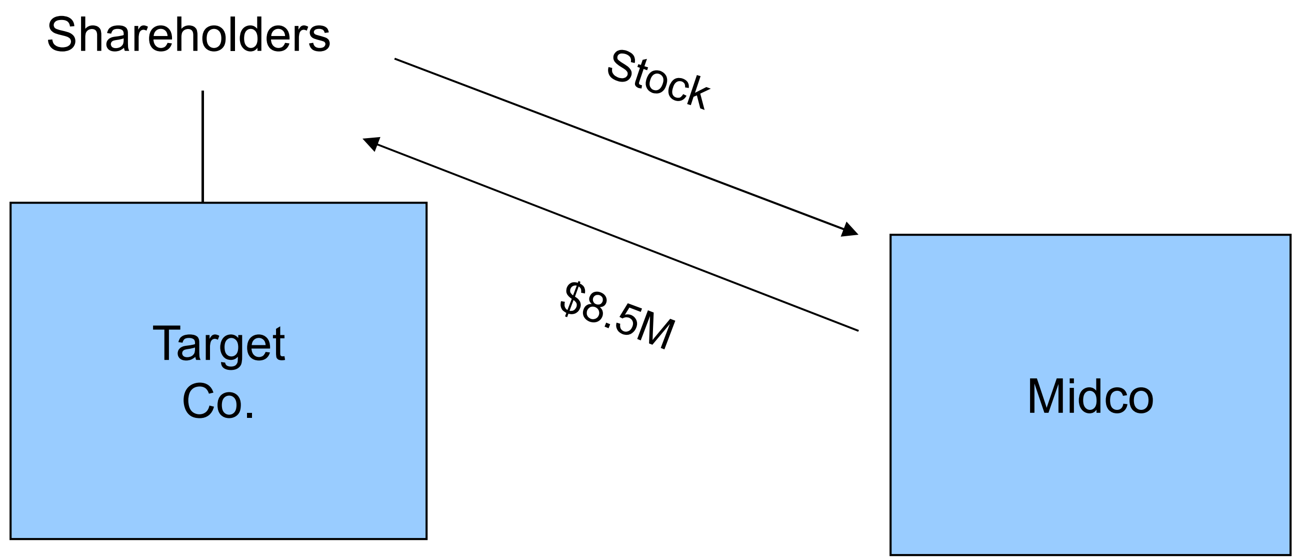
MIDCO TRANSACTION STEP 2



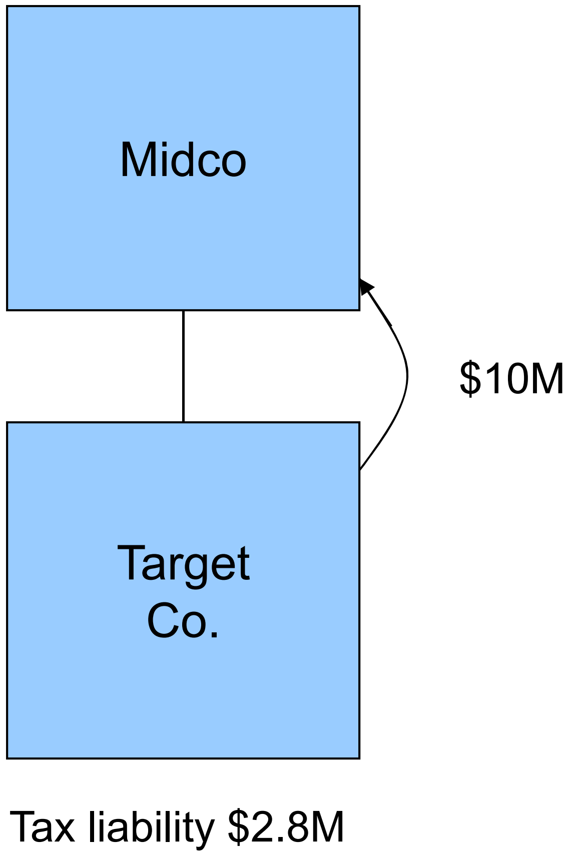
Cash $10M

Tax liability $2.8M

Net worth $7.2M

Sales price usually defined as cash balance less certain percentage of the tax liability – here, 55%

MIDCO TRANSACTION STEP 3



The transaction only makes sense if the $2.8M tax liability can be eliminated

There may be legitimate ways in which the tax liability could be reduced, but the promoter typically uses Son-of-BOSS, distressed asset/debt, or other tax shelters

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MIDCO TRANSACTION FINAL RESULTS

	Before	After
Midco		
Share of tax savings		$ 1.5M
Shareholders		
Net worth of Target	$ 7.2M	7.2M
Share of tax savings		1.3M
IRS	2.8M	0.0M
Total	$10.0M	$10.0M

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WHY TRANSFEREE LIABILITY?

- The midco/promoter has made itself judgment proof
- Only source of payment for the tax liability is the selling shareholders or the buyer
- But transferee liability only applies if there is a transfer of money or property from the target company, to the shareholders or the buyer, for less than REV

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GOVERNMENT WINS

- *CHC Industries, Inc.*, T.C. Memo 2011-33 (2/2/11)
- *Feldman*, T.C. Memo 2011-297 (12/27/11)

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TAXPAYER WINS

- *LR Development Co.*, T.C. Memo 2010-203 (9/16/10)
- *Griffin*, T.C. Memo 2011-61 (3/15/11)
- *Frank Sawyer Trust*, T.C. Memo 2011-298 (12/27/11)
- *Slone*, T.C. Memo 2012-57 (3/1/12)
- *Salus Mundi Foundation*, T.C. Memo 2012-61 (3/6/12)
- *Starnes*, T.C. Memo 2011-63 (3/15/11), *aff'd*, 680 F.3d 417 (4th Cir. 5/31/12)

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ON APPEAL

- *Frank Sawyer Trust*, 1st Cir. No. 12-1586, docketed 5/11/12, argued 11/8/12
- *Slone*, 9th Cir. No. 12-72464, docketed 8/3/12, briefing complete
- *Salus Mundi Foundation*, 9th Cir. No. 12-72527, docketed 8/10/12, final brief due 3/25/13
- *Feldman*, 7th Cir. No. 12-3144, docketed 9/19/12, briefing started

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KEY ISSUES/QUESTIONS

KEY ISSUES/QUESTIONS

- **Did the target company transfer property to the purported transferee?**
- **Is the tax liability an existing claim at the time of the transfer, or is it a future claim?**
- **Whose knowledge or intent is relevant?**

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WAS THERE A TRANSFER?

- **Buyer of assets – usually the transfer is for REV, so no transferee liability**
  - **But watch the details!** ***LR Development*** **and also** ***CHC Industries***
- **Selling shareholders – technically receive payment from the midco, not the corporation; no transfer unless the IRS is allowed to recast the transaction**

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RECASTING THE TRANSACTION

- Using federal tax law, substance-over-form or economic substance doctrines – government's preference

- State law usually allows recasting the transaction if the shareholders had actual or constructive knowledge that the midco would likely not pay its legitimate debts

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SUBSTANCE OVER FORM

- **Some older transferee liability cases held that the sale of stock in a corporation holding only cash was, in substance, a liquidation**
  - **“when a corporation owns just cash . . . The corporation has already been effectively liquidated” *Owens*, 568 F.2d 1233 (6th Cir. 1977)**
- **Most (but not all) of the new transferee liability cases have declined to recast the transaction**

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SUBSTANCE OVER FORM, cont'd

- ***Starnes* – substance over form doctrine is not applicable, because *Comm'r v. Stern*, 357 U.S. 39 (1958) said that determination of transferee liability is based solely on state law**

- ***Frank Sawyer Trust* and *Slone* – government can recast the transaction under substance over form, but only if there is a "preconceived plan to avoid taxation"; Respondent didn't demonstrate such**

- ***Starnes* (dissent) and *Feldman* – recast the transaction; lacked business purpose and economic substance, and in substance was a liquidation**

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SUBSTANCE OVER FORM, cont'd

- **This is likely to be a key issue in the appeals of *Frank Sawyer Trust*, *Feldman*, *Salus Mundi Foundation*, and *Slone***

- **Chances of the government prevailing?**

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WHY THIS IS IMPORTANT

- Government believes substance over form is a more objective determination and would not require the same degree of proof of the transferees' knowledge and intent
- For example, most courts have been reluctant to recast the transaction under state law, based on "actual or constructive knowledge of the scheme" standards

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CONSTRUCTIVE KNOWLEDGE

- ***Frank Sawyer Trust*** **– "Further inquiry was likely warranted considering Fortrend agreed to pay the trust more than the net book value of the company when the only assets were cash and the only liabilities were income tax liabilities"; the extent of inquiry was not clear; but Respondent didn't meet the burden of proof**

- ***Salus Mundi Foundation*** **– no inquiry made, but none required under the circumstances**

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CONSTRUCTIVE KNOWLEDGE, cont'd

- ***Starnes*** **– the Tax Court reasonably found "that no reasonably diligent inquiry . . . would have disclosed Midcoast's intent to fail to pay its taxes"; "even though [they] might have conducted further inquiry, such a hypothetical effort would not likely have revealed" the plan**

- **These conclusions frequently rely on the hypothetical possibility that the taxes could have been avoided legitimately**

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LEGITIMATE TAX AVOIDANCE

- ***Frank Sawyer Trust* – "there are legitimate tax planning strategies to defer or avoid paying taxes"**

- ***Salus Mundi Foundation* – "There are legitimate transactions that [the promoter] could have contemplated to offset or defer [the target's] built-in gains, and respondent has failed to show why" the shareholders should have known the promoter "planning on using a fraudulent tax strategy"**

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LEGITIMATE TAX AVOIDANCE, cont'd

- **Legitimate tax avoidance in these transactions may not be as easy as the courts suggest**
  - ***Feldman*** **– the "asset recovery" story is "preposterous"**
- **But Respondent has the burden of proof, and it's difficult to prove a negative**

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CONSEQUENCES OF APPEALS RESOLUTION?

- **A reaffirmation of *Stern* and *Starnes*, that federal law is not applicable to the determination of transferee liability, would be helpful to selling shareholders in midco transactions, by reducing the likelihood of being found to be "transferees"**

- **But it could have unanticipated effects in other areas; we could not rely on federal tax law with respect to other aspects of transferee liability**

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KEY ISSUES/QUESTIONS

- **Did the target company transfer property to the purported transferee?**
- **Is the tax liability an existing claim at the time of the transfer, or is it a future claim?**
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EXISTING CLAIM OR FUTURE CLAIM?

- **If the tax liability is a future claim, only the "actual fraud" and "risk of insolvency" categories are available; both involve subjective determinations of the transferee's knowledge or intent, difficult to prove**

- **If the tax liability is an existing claim, the "constructive fraud" category is available, which requires showing only a transfer for less than REV and resulting insolvency, both objective determinations**

- **The law is unclear, but evolving in an unfavorable direction**

HISTORICALLY

- **Most transferee liability cases involved transfers after the tax return was filed but before an audit and assessment**

  - **"The United States is considered a creditor 'from the date when the obligation to pay income taxes accrues,' essentially on April 15 of the year following the tax year in question" – *United States v. Green*, 201 F.3d 251 (3d Cir. 2000)**

  - **Government was a creditor on 4/15/78 for income tax liability for the 1977 tax year – *Roland v. United States*, 838 F.2d 1400 (5th Cir. 1988)**

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MIDCO CASES ARE CHANGING THAT

- *LR Development*
  - Tax liability is a contingent claim as of the date the assets are sold, for purposes of determining insolvency
  - But assumed *arguendo*, in discussion of the badges of fraud, that the tax liability did not become a debt until March 15 of the year following the tax year
  - And FN 50, discussing risk of insolvency category, says "tax is considered as due and owing on the date on which the tax return in which the tax must be reported is required to be filed"

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MIDCO CASES ARE CHANGING THAT, cont'd

- ***Feldman***
  - "Income tax liabilities arising from the sale of corporate assets are 'claims' existing at the time of the sale."
- ***Starnes***
  - Government argued constructive fraud (applicable only to existing claims), but the court did not explicitly address the question of whether the income tax liability was an existing claim

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EXISTING CLAIMS?

- The government is beginning to argue, and courts are accepting, that the tax liability is an existing claim at the date of the transfer, before the end of the tax year

- This might be the right answer for midco transactions where the corporation had reduced its assets to cash, but the courts have not explained their reasoning or expressly limited their conclusion to that scenario

- Might this spill over into other transferee liability cases?

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KEY ISSUES/QUESTIONS

- **Did the target company transfer property to the purported transferee?**
- **Is the tax liability an existing claim at the time of the transfer, or is it a future claim?**
- **Whose knowledge or intent is relevant?**

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KNOWLEDGE AND INTENT

- **The <u>transferee's</u> actual or constructive knowledge is relevant to recasting the transaction under state law**

- **The <u>debtor's</u> knowledge or intent is relevant to the determination of transferee liability for the actual fraud or risk of insolvency categories**

  - **Even if the transferee has no knowledge of actual fraud or risk of insolvency, he can be held liable based on the debtor's intent**

KNOWLEDGE AND INTENT, cont'd

- **In the midco transaction context, the debtor is a corporation; whose knowledge and intent are relevant?**
  - **Owner immediately before the transaction (the selling shareholders)?**
  - **Owner immediately after the transactions (the midco/promoter)?**
- ***LR Development* looked at the midco promoter!**

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CONCLUSION

- The IRS considers the midco transactions abusive and will continue to pursue them aggressively

- The law of transferee liability is evolving as a result of these cases, in ways that may be unfavorable to taxpayers

- And those changes may apply to all transferee liability cases, rather than just midco transactions

QUESTIONS?

[Updates on following page]

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UPDATE TO TRANSFEREE LIABILITY PRESENTATION

After this presentation on March 4, 2013, to the Dallas Bar Association, there have been two interesting developments concerning transferee liability.

First, on March 29th, the First Circuit issued its decision in *Frank Sawyer Trust of May 1992 v. Commissioner*. A brief discussion of the implications of the case, along with a link to the court's opinion, is available at http://taxlawyer.typepad.com/blog/2013/04/new-development-in-transferee-liability.html

Second, on April 10th, the administration issued its budget for fiscal year 2014. The budget included a proposal to combat the midco tax shelters by imposing direct liability for the selling stockholders. This proposal implicitly recognizes that a different approach might be necessary because the government continues to lose these transferee liability cases. A brief discussion of the proposal, along with a link to the Treasury Department's "Greenbook," is available at http://taxlawyer.typepad.com/blog/2013/04/a-proposed-legislative-fix-to-the-midco-tax-shelter.html

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HOW TO REQUEST (AND GET) A PLR

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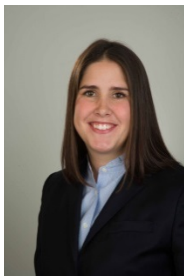

Meredith is a licensed Texas attorney with Cantrell & Cowan, PLLC. She received her law degree from Cumberland University and her LLM from the University of Houston. She handles a broad range of income, estate, and gift tax matters, focusing on creative planning strategies and ongoing compliance requirements. Her services include advising clients on wealth transfer plans, assisting clients with business formation and continuance, and analyzing the tax effects of proposed transactions and litigation settlement agreements.

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I. INTRODUCTION

Each year the IRS dedicates its first published revenue procedure to the process for obtaining a private letter ruling. For 2013, applicants should rely on Revenue Procedure 2013-1 for guidance and instructions on what issues the IRS will generally rule on and what should be attached to the ruling request.[1] Rev. Proc. 2013-1 also contains references to other revenue procedures and notices that supplement it pertaining to certain specific code sections. In addition, the IRS publishes two other revenue procedures listing general and specific matters upon which the Service will not rule. Revenue Procedure 2013-3 contains the domestic no-rule areas and 2013-7 contains the international no-rule areas.[2] It is important to read Rev. Proc. 2013-1 and the no-rule procedures before beginning the application process.

These revenue procedures contain valuable information that can greatly streamline the process of obtaining a ruling and reduce the cost. However, there are also many factors that are not covered in the published guidance and that may be critical to the practitioner's success in obtaining the ruling. This discussion provides both an overview of the application process as outlined in the revenue procedures as well as some practical tips for requesting a private letter ruling.

II. WHAT ISSUES ARE APPROPRIATE FOR A PLR?

A private letter ruling, or PLR, is a written statement from the IRS under the jurisdiction of the Associate Chief Counsel's office in response to the taxpayer's request for an opinion on the tax effects of a proposed or completed transaction.[3] A taxpayer may rely on a letter ruling received from the Associate Chief Counsel's Office as long as the transaction is carried out substantially as proposed.[4] A request for a ruling must generally be submitted before the return is filed for the year in which the transaction is completed. However, there are a few exceptions, such as for employment and excise tax issues, which allow a request to be submitted after a return is filed.

The Associate Chief Counsel's Office issues rulings on a wide variety of issues and has seven offices to handle ruling requests. These include Corporate, Financial institutions and Products, Income Tax and Accounting, International, Passthroughs and Special Industries, Procedure and Administration, and Tax Exempt and Government Entities.[5] These offices handle matters involving income tax, estate and gift tax, generation-skipping tax, employment and excise tax, and procedural and administrative matters.[6] They also handle substantive provisions of an income or estate tax treaty.[7]

A request to extend the time for making a regulatory election under Reg. § 301.9100-3 is a letter ruling request. Therefore, it must be in the general form of and meet the general requirements of a letter ruling request.[8] Such requests can be submitted even after the return to which the transaction relates is filed, while the return is being examined by the IRS, or while the matter is

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[1] Rev. Proc. 2013-1, 2013-1 IRB 1 (Dec. 31, 2012)
[2] Rev. Proc. 2013-3, 2013-1 IRB 113 (Dec. 31, 2012); Rev. Proc. 2013-7, 2013-1 IRB 233 (Dec. 31, 2012).
[3] Rev. Proc. 2013-1, § 2.01.
[4] Id. at § 11.03.
[5] Id. at § 3.
[6] Id. at § 5.
[7] Id. at § 7.01(6).
[8] Id. at § 5.03.

on administrative or judicial appeal. It is important to note that Reg. § 301.9100-3 only applies to extensions of time for elections whose due date is prescribed by a regulation and not a statute. However, in practice, the IRS regularly issues extensions of time to make elections whose deadlines are set by statute.

Ruling requests under Reg. § 301.9100-3 must include detailed affidavits by the taxpayer and third parties describing the events that led to the failure to make a valid election and the discovery of the failure.[9] When the taxpayer relied on a qualified tax professional for advice, the taxpayer's affidavit must describe the engagement and responsibilities of the professional as well as the extent to which the taxpayer relied on the professional. Detailed affidavits must also be submitted by the taxpayer's return preparer, any individual (including an employee of the taxpayer) who made a substantial contribution to the preparation of the return, and any accountant or attorney, knowledgeable in tax matters, who advised the taxpayer with regard to the election. An affidavit must describe the engagement and responsibilities of the individual as well as the advice that the individual provided to the taxpayer. All affidavits submitted must be signed under penalties of perjury.

Letter rulings can also be used to request a change of accounting method on Form 3115. Rev. Proc. 2013-1 contains extensive guidance on changes of accounting method. However, changes of accounting method are beyond the scope of this discussion.

III. WHAT ISSUES ARE <u>NOT</u> APPROPRIATE FOR A RULING?

The IRS specifically identifies certain matters on which it will not issue a private letter ruling. Generally, the Associate Office will decline to issue a PLR is the issue is frivolous, hypothetical, or if the issue is sufficiently covered by the relevant statute, regulation, or case law.[10] The IRS is generally reluctant to issue private letter rulings pending the adoption of temporary or final regulations addressing the matter. Nor will the IRS issue “comfort rulings” with respect to an issue that is clearly and adequately addressed by substantial authority.[11]

In addition, the IRS will generally decline to rule if the identical issue is involved in the taxpayer’s return for an earlier period and that issue: (a) is being considered by a Field office, (b) is being considered by Appeals, (c) is pending in litigation for the taxpayer or a related taxpayer, (d) has been examined by a Field office or considered by Appeals and the statute of limitations for assessment or on filing a claim for refund has not expired, or (e) has been examined by a Field office of considered by Appeals and a closing agreement has not been entered into by either the Field office or Appeals.

Other general situations in which the IRS will not issue a private letter ruling include:[12]

(a) if issuing a PLR is not in the interest of sound tax administration,

(b) if the issue is part of a larger integrated transaction not included in the request, unless the other issues fall under no-rule areas,

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[9] Reg. § 301.9100-3(e).
[10] Rev. Proc. 2013-1, § 6.
[11] Id. at § 6.11.
[12] *Id*.

(c) if the issue involves which of two entities is a common-law employer,

(d) if the applicant is a business association or group with an issue concerning the application of tax laws to its members,

(e) if the taxpayer does not provide its tax status, liability, or reporting obligations,

(f) if the applicant is a foreign government,

(g) if the issue involves the federal tax consequences of proposed federal, state, local, municipal, or foreign legislation, or

(h) if the issue cannot be resolved before a regulation or other published guidance is issued.

In addition to the general circumstances outlined above, Rev. Proc. 2013-3 and 2013-7 identify specific transactions on which the Service will not rule either because of the inherently factual nature of the issue or for other reasons. The "no-rule" areas are listed by Internal Revenue Code section and divided into four categories – a) those areas on which the IRS will not rule under any circumstances, b) those areas on which the Service will not ordinarily rule, absent some unique and compelling reason, c) those areas on which the Service has temporarily suspended rulings because the matter is under study, and d) those areas on which the Service will not rule because there are automatic approval procedures for these matters. Some of the no-rule areas involve surprisingly common transactions such as:[13]

(a) Section 83. Property Transferred in Connection with Performance of Services. Whether a restriction constitutes a substantial risk of forfeiture, if the employee is a controlling shareholder. Also, whether a transfer has occurred, if the amount paid for the property involves a nonrecourse obligation.
(b) Section 101(a). Certain Death Benefits. Whether there has been a transfer for value under § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.
(c) Section 102. Gifts and Inheritances. Whether a transfer is a gift within the meaning of § 102(a).
(d) Section 121. Exclusion of Gain from Sale of Principal Residence. Whether property qualifies as the taxpayer's principal residence.
(e) Section 162. Trade or Business Expenses. Whether compensation is reasonable in amount.
(f) Section 170. Charitable Contributions and Gifts. Whether a charitable contribution deduction under § 170 is allowed for a transfer of an interest in a limited partnership

[13] Rev. Proc. 2013-3, § 3.01.

or a limited liability company taxed as a partnership to an organization described in § 170(c).

(g) Section 213. Medical and Dental Expenses. Whether a capital expenditure for an item that is ordinarily used for personal, living, or family purposes, such as a swimming pool, has as its primary purpose the medical care of the taxpayer or the taxpayer's spouse or dependent, or is related directly to such medical care.

(h) Section 704(b). Determination of Distributive Share. Whether the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit (or an item thereof) has substantial economic effect or is in accordance with the partner's interest in the partnership.

Rev. Proc. 2013-3 also lists general areas on which the Service will not rule. These include whether a transaction has economic substance, a bona fide business purpose, reasonable cause, due diligence, good faith, or similar instances that require a factual determination. The service will also not rule on matters involving Circular 230 or whether a proposed transaction would subject the taxpayer to criminal penalties, to name a few. The applicant should thoroughly review the no-rule areas to make sure that his or her subject matter is not on the precluded list.

The issues on which the Service will not *ordinarily* rule without a unique or compelling reason, include:[14]

(a) Sections 83 and 451. Property Transferred in Connection with Performance of Services. When compensation is realized by a person who, in connection with the performance of services, is granted a discounted nonstatutory option without a readily ascertainable fair market value.

(b) Section 167. Depreciation. What a property’s useful life should be.

(c) Section 678. Beneficiary Defective Grantor Trust. Whether a person will be treated as the owner of any portion of a trust over which that person has a power that would cause that person to be the owner of the trust under § 671, if the trust purchases property from that person with a note and the trust was funded by the grantor with only a nominal amount compared to the value of the property purchased.

When requesting a ruling on an issue that the Service does not ordinarily rule on, it a good idea to request a pre-submission conference before beginning the application. A pre-submission conference can be requested in writing or by phone at one of the numbers listed in Rev. Proc. 2013-1.[15] The IRS can make helpful suggestions, such as how to frame the issue or let you know how they would be inclined to rule based on your facts and circumstances. The Service may also suggest an alternate course of action, such as seeking the advice of competent authority for international issues. These tips can avoid many frustrating hours with an Associate Chief Counsel representative who has made up his mind not to issue the ruling. It pays to be persistent and tenacious during the entire application process. But it does not always lead to success.

[14] Rev. Proc. 2013-3, § 4.01.

[15] Rev. Proc. 2013-1, § 10.07.

IV. WHO MAY REPRESENT THE TAXPAYER IN A RULING REQUEST

The request for a letter ruling or determination letter must be signed and dated by the taxpayer or the taxpayer's authorized representative. To sign the request or to appear before the Service in connection with the request, the taxpayer's authorized representative must be an attorney, CPA, enrolled agent, enrolled actuary, enrolled retirement plan agent, or a person with a "Letter of Authorization" as those persons are described in Treasury Department Circular No. 230, 31 C.F.R. part 10.[16] Registered return preparers and other tax return preparers not described above may not sign the request, appear before the Service, or represent a taxpayer in connection with a letter ruling request.[17]

In addition, a regular full-time employee representing his or her employer, a general partner representing his or her partnership, a *bona fide* officer representing his or her corporation, association, or organized group, a regular full-time employee representing a trust, receivership, guardianship, or estate, or an individual representing an immediate family member may sign the request or appear before the Service in connection with the request.

Form 2848, *Power of Attorney and Declaration of Representative*, should be used to provide the representative's authority.

V. THE PROCEDURE FOR REQUESTING A RULING

A private letter ruling request should be submitted to one of the seven Offices of Associate Chief Counsel, depending on the primary Internal Revenue Code section affected. The offices are Corporate, Financial Institutions and Products, Income Tax and Accounting, International, Passthroughs and Special Industries (includes estate and gift tax matters), Procedure and Administration, and Tax Exempt and Government Entities. If in doubt as to where to send the request, the applicant should call one of the phone numbers listed in Rev. Proc. 2013-1.[18] If a ruling request covers more than one subject area, it may be ruled upon by more than one Associate Office. Each Associate Office will determine whether it may issue a private letter ruling on the matter submitted. It may also refer the matter to another Office.

a. Determine whether a pre-submission conference is needed

A taxpayer may request a pre-submission conference to discuss the taxpayer's area of concern and to receive guidance about substantive or procedural matters relating to the request. Whether the pre-submission conference will be granted is at the discretion of the appropriate Associate Office. The taxpayer should request the conference in writing or over the telephone and should provide the Associate Office with a brief overview of the issues at hand. The contact information for requesting a pre-submission conference may be found in Revenue Procedure 2013-1.[19]

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[16] Rev. Proc. 2013-1, § 7.01(13).
[17] *Id*.
[18] Rev. Proc. 2013-1, § 10.07(1).
[19] Id. at § 10.07.

b. Draft the PLR request

Appendix B of Rev. Proc. 2013-1 contains a sample PLR Request, which includes a statement of facts, an analysis of the material facts, and a discussion of the authorities both supporting and contrary to the taxpayer's position. The facts should include the names, addresses, telephone numbers, taxpayer identification numbers, accounting periods, and methods of accounting for all interested parties. If the taxpayer is a business, the facts should also include a description of the business and the business reasons for the proposed transaction. All taxpayers should include a detailed description of the transaction and the requested tax treatment of the transaction.

The taxpayer should provide a thorough analysis of the material facts of the transaction and the law as it applies to the transaction. The analysis is much like a lawyer's trial brief. It must state the taxpayer's conclusion, an explanation of the grounds for the conclusion, and any relevant authorities. The analysis should include supporting as well as contrary authorities. If the law is uncertain on an issue or if there are no relevant contrary authorities, the taxpayer should include a statement to that effect. Additionally, if there is pending legislation that would affect the proposed transaction, the taxpayer should identify the pending legislation in the PLR request.

c. Include the required statements

Private letter rulings are open to public inspection pursuant to IRC § 6110. To protect the taxpayer's privacy, the request should include a deletion statement specifying the deletions desired so that personal information is not available to the public. A basic deletion statement will request that the names, addresses, and identifying numbers of the taxpayer should be removed from the private letter ruling. If the taxpayer wishes to have additional information, such as the taxpayer's residence, occupation, or other personal facts deleted from the PLR, the taxpayer should include an additional copy of the request with brackets around the information to be deleted. The deletion statement should include the statutory basis for the deletion pursuant to IRC § 6110.

Appendix C of Revenue Procedure 2013-1 also provides a Checklist, which must be completed and placed on top of the private letter ruling request. This checklist requires the taxpayer to indicate that all relevant portions of the request have been completed and indicate the location of the response in the application request. Therefore, it is helpful to number the workpapers and the exhibits included in the ruling. The checklist must be signed and dated by the taxpayer or his representative. Failure to include the checklist with the request may delay action on the Associate Office's review of the request.

Requests made pursuant to Treasury Regulation § 301.9100 must include a statement regarding whether the issue is part of an earlier return of the taxpayer or a related party that is currently or has previously been under examination, before Appeals, or before a Federal court. If the tax year is under examination or before Appeals or a Federal court, the taxpayer should notify the Associate Office and include the name and telephone number of the examining officer or appeals officer.

All applicants must include a statement regarding whether the same or similar issue was previously ruled on or whether a request for the issue has been submitted previously.[20] If the

[20] Rev. Proc. 2013-1, § 7.01(5).

issue has been ruled on or submitted previously, the taxpayer must give the date of the request, the date the request was withdrawn or ruled upon, and any details of the Service's consideration of the issue. In other words, the IRS wants to know if this is the second time you have requested a ruling on this or a similar issue.

If an income or estate tax treaty is involved, the applicant must include a statement regarding interpretation of the relevant provision.[21] This statement must note whether (a) the tax authority of the other country has ruled on the same or similar issue for the taxpayer or a related taxpayer, (b) the tax authority of the other country has issued a closing agreement in that jurisdiction regarding the issue for the taxpayer or a related taxpayer, and (c) whether the same or similar issue for the taxpayer is being considered by the competent authority of the other jurisdiction.

And finally, the taxpayer must submit a statement that reads: "Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete."[22] The statement must be signed by the taxpayer; it may not be signed by the taxpayer's representative. For corporations, the request should be signed by an officer with personal knowledge of the facts. The person signing for a partnership, trust, or limited liability company should be the general partner, trustee, or member-manager who has personal knowledge of the facts.

Additional notations may be placed in the private letter ruling request requesting receipt of documents by fax or requesting a conference with the Associate Office. Requests for a conference may also be made following the submission of the PLR request.

d. Attach any documents pertinent to the transaction

Any documents that impact the transaction should be included with the ruling request. For example, an estate should include copies of any wills, codicils, trust documents, and disclaimers, while a corporation should submit its balance sheet and profit and loss statement. If any of the documents are in a language other than English, the taxpayer should provide a copy of the original document, as well as a certified English translation. If applicable, foreign laws should be submitted both in the official language of the country involved and in English. The English version of the relevant laws should be from either an official publication of the foreign government or a certified English translation. Original documents should not be submitted, as they will become part of the IRS's file and will not be returned. All documents should be labeled and attached to the request in alphabetical order.

e. Request expedited handling, if necessary

Although the Service typically processes private letter ruling requests in the order in which they are received, in certain circumstances the Associate Office will grant expedited handling of a request.[23] The taxpayer must demonstrate a compelling need for the expedited processing, such as avoidance of serious business consequences. If the taxpayer requests expedited handling, the private letter ruling request should have a notation on the top of the first page of the request that states "Expedited Handling is Requested. See page ____ of this letter." The Service has the

[21] Rev. Proc. 2013-1, § 7.01(6).
[22] Rev.Proc. 2013-1, 2013-1 I.R.B. 1, § 7.01.
[23] Id. at § 7.02(4).

discretion to grant or deny a request for expedited handling, and therefore urges taxpayers to submit the private letter ruling request well in advance of the proposed transaction.

Examples of a compelling need for expedited processing include situations in which a court or governmental agency has imposed a specific deadline for completing a transaction, or where a transaction must be completed expeditiously to avoid an imminent business emergency (such as the hostile takeover of a corporate taxpayer), provided that the taxpayer can demonstrate that need and the need for expedited handling, resulted from circumstances that could not reasonably have been anticipated or controlled by the taxpayer. To qualify for expedited handling in such situations, the taxpayer must also demonstrate that the taxpayer submitted the request as promptly as possible after becoming aware of the deadline or emergency.

f. Submit the request

Ruling requests can be submitted by regular mail or private delivery service. The package containing the request should be marked "RULING REQUEST SUBMISSION."[24] The appropriate user fee should be included with the private letter ruling request. The fee schedule may be found in Appendix A of Revenue Procedure 2013-1. Requests for relief under Reg. § 301.9100-3 are currently $10,000, requests for a change of accounting method are $7,000-$8,000, and most other rulings are $18,000.

Reduced user fees of $2,000 and $4,000 may be available for smaller taxpayers based on their gross income in the year preceding the ruling request. Individuals, estates, corporations, partnerships, and exempt organizations with gross income less than $250,000 pay only a $2,000 user fee. Those with gross incomes over $250,000 but less than $1,000,000 pay a $4,000 user fee.[25] Reduced fees also apply in situations where the taxpayer requests substantially identical letter rulings for multiple entities at the same time.[26] All user fees must be paid by check or money order payable to the Internal Revenue Service.

User fees are generally not refundable.[27] The Service will not return a user fee if the request is withdrawn, is procedurally deficient, or if additional information requested by the branch representative is not timely provided. If the IRS fails to rule on a request, and in other very limited circumstances, a user fee may be refunded.

Generally, the taxpayer should submit the original ruling request and one copy. However, if more than one issue is addressed, an additional copy should be submitted for each issue presented. Also, an original and two copies should be submitted if the taxpayer is requesting deletion of information other than names, addresses, and identifying numbers – the second copy should be a deleted version of the request).

[24] Id. at § 7.03(1).
[25] Rev. Proc. 2013-1, Appendix A, § B(2) (The taxpayer must include certification that it meets income requirements, which may be in the form of a statement or a copy of the taxpayer's return reflecting the taxpayer's gross income.)
[26] Rev. Proc. 2013-1, § 15.07.
[27] Id. at § 7.07(3).

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VI. AFTER THE REQUEST HAS BEEN SUBMITTED

a. Processing by the Service

A private letter ruling request is initially reviewed by the Docket, Records, and User Fee Branch of the Legal Processing Division of the Associate Chief Counsel (Procedure and Administration), which examines the request and assigns it to the appropriate Associate Office. The Associate Office then forwards the request to one of its branches for review.

After the request is received by the branch of the Associate Office, the representative in charge of the request has 21 days to contact the taxpayer. However, it has been the author's experience that the representative does not initiate the contact within 21 days and the taxpayer must call to check on the status of the ruling request. If the branch representative has had sufficient time to review the request, it will generally advise the taxpayer whether it has tentatively determined the ruling, whether additional information is needed, or whether it is unable to make a tentative determination due to the complexity of the case. Any minor modifications that should be made to the request will generally be addressed at this time. If more than one Associate Office is involved in reviewing the request, the branch representative will inform the taxpayer that the other branch representative will contact the taxpayer within 21 days after receiving the referral.

The taxpayer may check on the status of the private letter ruling request by contacting the Associate Office branch representative assigned to the private letter ruling. Many Associate Office personnel are working remotely and may be difficult to reach. Therefore, it is imperative that the practitioner obtain the representative's phone and fax number at the inception of the process so that phone tag can be minimized. Whenever possible, messages should be sent by fax.

The branch representative may request additional information to consider with the private letter ruling request. Any requested information must be provided within 21 days of the date of the information request or the PLR request may be closed. The branch representative may allow an extension of time for compliance with its request. If the taxpayer submits additional information by fax, telephone, or in person, the taxpayer should follow-up with a letter confirming receipt of the information by the branch representative.

Additionally, the taxpayer is entitled as a matter of right to one conference with the Associate Office. The Associate Office may request a conference, but otherwise the taxpayer must request the conference in writing. After the taxpayer has requested the conference, the branch representative will call the taxpayer to schedule the conference within 21 days of the telephone call from the branch representative. The conference may be in person or over the phone. Attendees will generally include the taxpayer, the branch representative assigned to the case, the person authorized to sign the PLR on the Associate Office's behalf. If the case is assigned to more than one associate office, the branch representative and authorized party from the additional Associate Office. The conference may not be recorded.[28] Additional conferences may be granted at the discretion of the IRS.

When the branch representative has reviewed the taxpayer's ruling request it will notify the taxpayer of the representative's conclusions. If representative contemplates ruling adversely on the taxpayer's position, it will provide the taxpayer an opportunity to withdraw the PLR

[28] Id. at § 10.03.

request.[29] The taxpayer must withdraw the request within 10 days, or the branch representative will issue an adverse ruling unless the representative grants the taxpayer an extension of time to respond. Although the withdrawal protects the taxpayer from receiving an adverse ruling, the Associate Office may nevertheless notify the relevant Field Office regarding its findings on the taxpayer's issue and issue its ruling as Chief Counsel's Advice, despite withdrawal by the taxpayer.

The IRS may also decline to rule where the taxpayer does not meet the ruling criteria set forth in Rev. Proc. 2013-1, the subject matter is on the IRS's no-rule list[30], or for other reasons, including "the interest of sound tax administration." If the IRS declines to rule, it will generally refund the taxpayer's user fee. The IRS decision not to rule is not appealable. Therefore, it pays to be cordial, patient, and persistent during the application process. The taxpayer should not be discouraged if the IRS throws roadblocks in his way. That's their job. It often helps to submit additional facts or reduce the scope of the ruling request to obtain at least a partial concession.

If the taxpayer receives a positive ruling from the Associate Office, the IRS will send the taxpayer a notice of proposed deletions/redactions to the ruling. The taxpayer has 20 calendar days to send a written notice to the Associate Office identifying any changes to the IRS's deletions. Twenty days after that, the Associate Office will mail the taxpayer its conclusions with respect to the deletions/redactions requested by the taxpayer. The taxpayer may request a delay of public inspection if there are good reasons for the delay. Otherwise the IRS will issue the private letter ruling, subject to public inspection under IRC § 6110.

b. Attach ruling to return

When the Associate Office issues the private letter ruling, the taxpayer must attach a copy of the PLR to the return that is relevant to the transaction for which the ruling was issued. If the taxpayer files electronically, the taxpayer should include a statement to the return that includes the date and control number of the private letter ruling.

If the relevant return is filed before the ruling is issued, the taxpayer should notify the Associate Office that the taxpayer has filed the return and must attach a copy of the PLR request to the return. Taxpayers that file their returns electronically should attach a statement with the return providing the date of the letter ruling request and the control number of the private letter ruling.

c. Modification or revocation of the PLR

The IRS may revoke or modify a private letter ruling and apply the revocation retroactively if a) there has been a misstatement or omission of controlling facts, b) the facts at the time of the transaction are materially different from the controlling facts on which the letter ruling was based, or c) the transaction involves a continuing action or series of actions and the controlling facts change during the course of the transaction.[31] The IRS can also revoke or modify a letter ruling prospectively if there has been a change in the applicable law.[32]

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[29] Id. at § 7.07.
[30] Rev. Proc. 2013-3 (domestic) and Rev. Proc. 2013-7 (international) provide a list of no-rule areas.
[31] Id. at § 11.05.
[32] Id. at § 11.06.

VII. CONCLUSION

Determining whether a private letter ruling request is appropriate for a taxpayer requires a good deal of judgment. While the advantages include reasonable certainty as to how a taxpayer's transaction will be treated by the IRS or a needed extension of time to make an election, there are also drawbacks to submitting a PLR request.

The most notable drawbacks are the time and money involved. The IRS will generally issue (or decline to issue) a private letter ruling within four to six months of receiving the request, although there is certainly no guarantee that the PLR will be issued within that time. Often a taxpayer's transaction cannot be postponed that long. In addition, private letter ruling user fees are steep. And if a transaction has already been completed, it may be harmful to draw the Service's attention to its questionable aspects. A careful balancing of the taxpayer's goals and circumstances is needed when deciding whether to request a private letter ruling.

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79th Annual API Federal Tax Forum

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April 29, 2013

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Today's Speakers

- Arthur Walker is a partner at Mayer Brown LLP. He advises clients on a broad range of domestic and international tax issues, including worldwide ETR reduction and efficiency planning, pre- and post-acquisition structuring and rationalization, IP migration, internal restructurings, acquisition and disposition planning, debt push-downs, LBO transactions, spin-offs, joint ventures, controlled foreign corporations (subpart F), investments in U.S. property, and M&A.
- Art has been listed among Washington's Top 1% Lawyers in the Tax field in Washington, DC by Washingtonian Magazine and, according to the Practical Law Company (PLC), is a "well-regarded tax partner with a particular focus on the tax aspects of corporate transactions."
- He is also an adjunct professor of Corporate Taxation at the Catholic University Law School in Washington, DC and often speaks and writes on international tax issues.

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Today's Speakers

- Shawn O'Brien is a Tax partner in Mayer Brown's Houston office. Shawn represents clients in all types of tax disputes with taxing authorities on international, federal and state levels. He routinely advises clients on various tax issues during tax examinations, in administrative appeals and as an advocate in trial and appellate litigation before the US Tax Court, US District Courts and US Court of Federal Claims. Shawn's tax controversy and litigation experience spans a broad range of areas, including transfer pricing controversies, debt v. equity issues, international withholdings, advance pricing agreements, "tax shelter" disallowances, estate and gift tax valuations, research and development tax credits, excise taxes, and changes in accounting methods.
- Shawn also advises foreign and domestic corporations, partnerships, and LLCs seeking corporate and tax advice in connection with various types of foreign and domestic transactions, including mergers and acquisitions, restructurings, divestitures, leveraged buyouts, structured financings and oil and gas transactions.
- Shawn is particularly focused on a variety of tax issues facing the energy industry including tax controversy, restructuring, acquisition and disposition of energy assets. Shawn serves as Chair of the Energy and Natural Resources Committee of the State Bar of Texas Tax Section.

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§ 304

- § 304 Generally
- Transfers of U.S. Target To U.S. Acquirers
- Transfers of U.S. Target To Foreign Acquirers
- Sandwich Structures New § 304(b)(5)(B)

§ 304 GENERALLY

- Effects of § 304
- Certain General § 304 rules
- Parent/Subsidiary Acquisitions
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- Other Issues To Consider

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Effects of § 304

- § 304 is designed to prevent controlling shareholders from claiming sale or exchange treatment on transactions that result in a distribution of corporate earnings without a significant reduction in control.
  - Originally aimed at shareholders trying to convert dividends to capital gains, which were taxed at a more favorable rate.
  - However, under current law, there is no preferential rate for capital gains for corporate shareholders.
- § 304 could affect the source of the purchase payments.
  - If a foreign parent sells stock in a U.S. company to another related U.S. company, absent §304, the gain would be treated as being from sources without the U.S.
  - If § 304 applies and the deemed redemption is essentially equivalent to a dividend, the deemed dividend would be treated as U.S. source income.
    - Capital gain on sale of stock by a nonresident is generally not U.S. source income. § 865(a)(2).
    - By contrast, dividends from a U.S. company are generally U.S. source income. § 861(a)(2).

Certain General § 304 Rules

- § 304(c) defines "control" as at least 50% of the voting power or at least 50% of the total value of all classes.
  - Special constructive ownership rules pursuant to § 318 apply with certain variations.
- § 304 treatment is not applicable to transactions between members of a consolidated group if the parties to the § 304 transactions are members after the sale.
  - See Treas. Reg. § 1.1502-80. But consider state, local and non-U.S. tax treatment of this transaction.
- If the reduction in the shareholder's interest in the deemed distribution fails all of the § 302(b) redemption tests, then the deemed distribution is a dividend to the extent of:
  - The acquiring corporation's E&P, and then
  - The issuing corporation's E&P.
- The deemed dividends from the acquiring corporation's E&P and the issuing corporation's E&P are generally considered to be received directly from the acquiring or issuing corporation, respectively. See Rev. Rul. 91-5.

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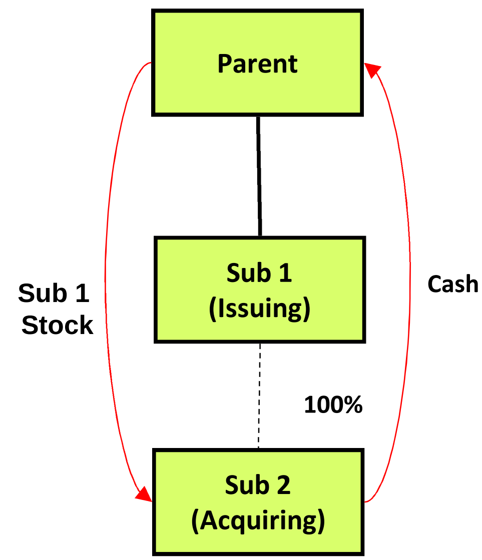
Parent/Subsidiary Acquisitions

- § 304(a)(2) applies when:
  - One corporation (Sub 2) acquires from a shareholder (Parent) of another corporation (Sub 1) stock in such other corporation, and
  - The issuing corporation (Sub 1) controls the acquiring corporation.
- The distributed property is treated as a distribution to Parent in redemption of the stock of the issuing corporation (Sub 1).
- Dividend equivalence under § 302(b) is tested by reference to the issuing corporation's (Sub 1) stock.



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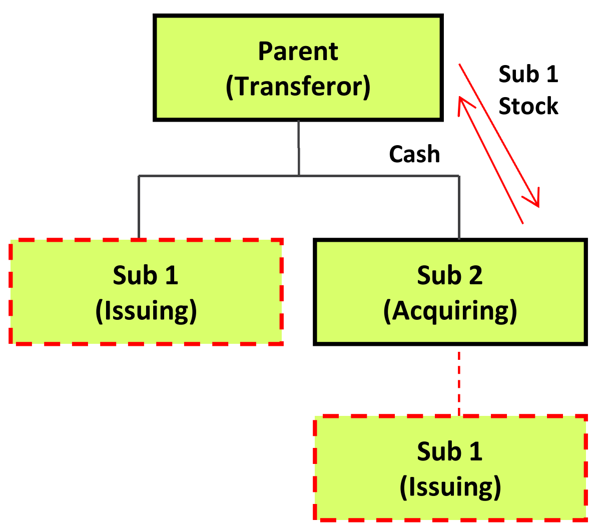
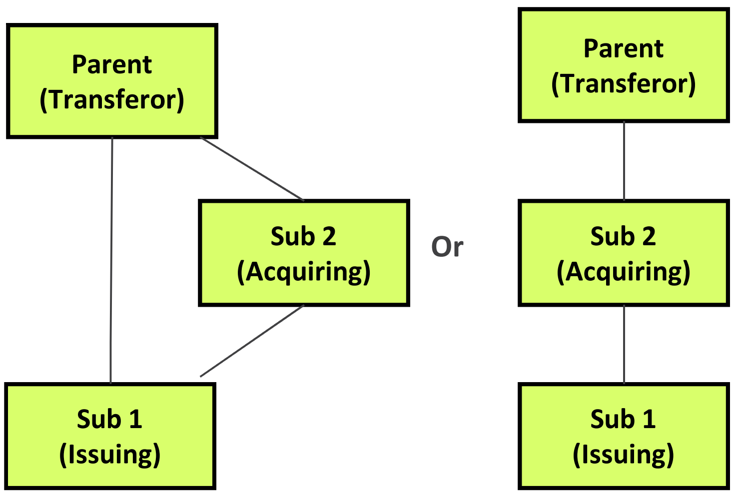
Brother/Sister Acquisitions

- § 304(a)(1) applies when:
  - One or more persons are in control of each of two corporations (Parent), and
  - In exchange for property, one of the two corporations (Sub 2) acquires stock in the other corporation (Sub 1) from the person in control.

Sub 2 acquires stock of Sub 1 for property



Structure after the acquisition



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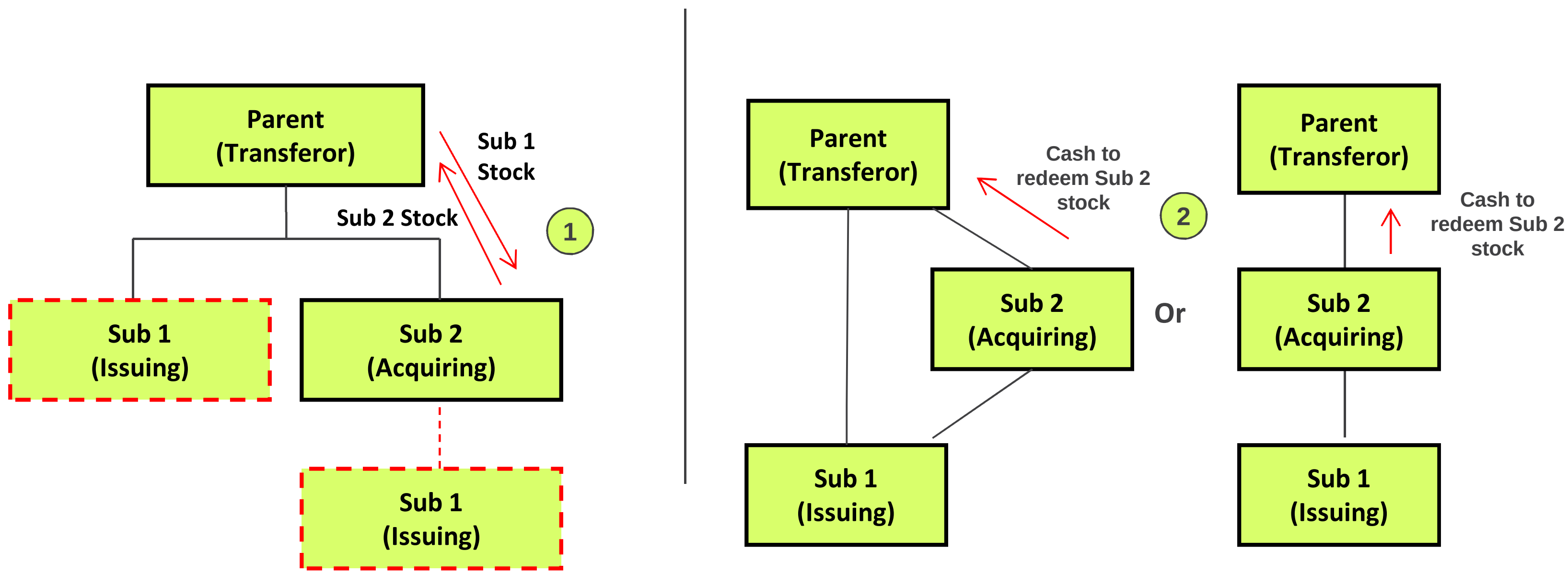
Brother/Sister Acquisitions (cont'd)

- Under § 304, the following is deemed to occur for U.S. tax purposes:
  - Step 1: Parent is deemed to contribute its Sub 1 stock to Sub 2 in exchange for Sub 2 stock equal to the contributed stock value ("new Sub 2 stock").
  - Step 2: Sub 2 is then deemed to redeem Parent's new Sub 2 stock for the amount of property that Sub 2 paid for the shares.
- Dividend equivalence is tested by reference to the issuing corporation's (Sub 1's) stock.



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Other Issues To Consider

- In any transaction, it is important to consider the potential applicability of anti-abuse rules:
  - § 269
    - § 269(a)(1) denies certain tax benefits where a person acquires, directly or indirectly, control of a corporation for the principal purpose of evading or avoiding federal income tax by securing the benefit of a deduction, credit or other allowance that such person or corporation would not otherwise enjoy.
    - § 269(a)(2) applies in the same way as § 269(a)(1), except that it applies when a person acquires property of another corporation and receives a carryover basis in the property.
  - Economic Substance
    - The economic substance doctrine was recently codified in § 7701(o), applicable to transactions entered into after March 30, 2010.
    - Under the § 7701(o), a transaction or series of transactions has economic substance only if (a) the transaction changes in a meaningful way (apart from U.S. federal income tax effects) the taxpayer's economic position *and* (b) the taxpayer has a substantial purpose (apart from U.S. federal income tax effects) for entering into such transaction.
    - The codification is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are generally respected.

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Application of the Codified Economic Substance Doctrine

- The statute does not define when the ESD is to apply
- Application is determined in the same manner as if the ESD had never been codified. §7701(o)(5)(C).
- A transaction is treated as having economic substance only if *both* of the following are met:
  - Objective Prong. "[T]he transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position." §7701(o)(1)(A).
  - Subjective Prong. "[T]he taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into [the] transaction." §7701(o)(1)(B).
- Provides a legislative answer to the split among Circuits
- Imposes a 20% strict liability penalty on any transaction disallowed because of the codified economic substance doctrine

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IRS Guidance on Applying ESD

- Announcement issued in September 2010 (LMSB-20-0910-024)
  - Mandated review and approval by Director of Field Office before the section 6662(b)(6) economic substance penalty can be imposed
- Directive released on July 15, 2011 (LB&I-4-0711-015)
  - Describes certain categories of transaction to which application of the codified economic substance doctrine would be inappropriate:
    - Including the choice to enter into transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C
  - Limited application of the strict liability penalty to the economic substance doctrine only, not to any "similar rules of law"
- IRS Chief Counsel Notice (CC-2012-008)

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Other Judicial Doctrines

- Step Transaction Doctrine
- Substance-Over-Form Doctrine
- Sham Transaction Doctrine
- Sham Partnership Doctrine

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TRANSFERS OF U.S. TARGET TO U.S. ACQUIRERS

- § 304 Base Cases
- General Withholding
- Complications with Applying Treaties To § 304
- Alternatives To Avoid § 304

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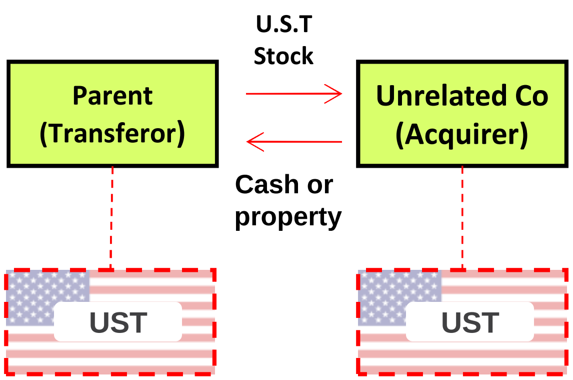
§ 304 Base Case: Sale of U.S. Subsidiary To Unrelated Acquirer

- Foreign Parent (FP) sells U.S. Target (UST) to an unrelated Acquirer.
- Capital gain on sale of UST stock by FP is generally not U.S. source income. § 865(a)(2).
- Creates a trap for the unwary when FP sells UST to a related party.



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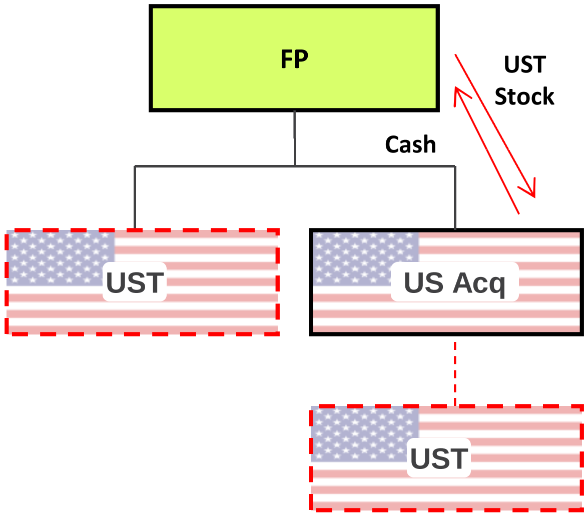
§ 304 Base Case: Sale of U.S. Subsidiary To Related U.S. Acquirer

- Foreign Parent ("FP") sells U.S. Target ("UST") to a related U.S. Acquirer ("US Acq").
- The recasted deemed contribution of the UST shares to U.S. Acq is generally tax-free under § 304.
- Because FP owns 100% of US Acq before and after the deemed redemption of its "new" U.S. Acq shares, the redemption will treated as a dividend distribution to the extent of the relevant entities' E&P.
- Under the § 304 E&P ordering, the tax rules first look to US Acq's E&P and then to UST's E&P for dividend characterization.
- Thus, to the extent E&P is present in either U.S. corporation, some or all of the purchase price will be treated as a dividend generally subject to the U.S. withholding tax regime.



General Withholding

- § 881(a)(1) imposes withholding of tax at 30% on foreign corporations that receive U.S.-source fixed or determinable annual or periodical (FDAP) income.
  - § 861(a)(2) provides that dividends are from sources in the U.S. if paid by a domestic corporation.
- § 1441 requires withholding agents to withhold 30% on a gross basis of U.S. source FDAP income paid to foreign persons.
  - Withholding agents are persons having control, receipt, custody, disposal, or payment of any of the items of income that are subject to withholding.
- FDAP income includes payments of dividends from U.S. corporations, including divided deemed paid under § 304.
  - Under Treas. Reg. §1.1441-3(c), unless certain exceptions apply, a corporation making a distribution with respect to its stock is required to withhold 30% on the entire amount of the distribution.

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General Withholding (cont'd)

- Withholding rate may be reduced by treaty. Treas. Reg. §1.1441-6.
  – Deemed nature of dividend presents some challenges to eligibility for reduced rates of withholding:
    - Determining appropriate treaty.
    - Direct ownership (may be manageable under Rev. Rul. 92-85).
    - Threshold requirement with respect to percentage ownership of voting stock.
    - 12-month holding period.

Withholding: Issues to Consider During Exam

- Recent developments reveal IRS plans for increased enforcement activity relating to payments to foreign persons
  – IRM 4.10.21, "U.S. Withholding Agent Examinations – Form 1042"
  – Includes procedures that IRS Revenue Agents are to follow when examining a U.S. Withholding Agent's Form 1042 filings
- Focus will be on "vendor payments:"
  – Payments to professional services firms, licensing fees, rents and royalties, dividend payments, etc.

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Withholding: Issues to Consider During Exam

- U.S. taxpayers making payments to foreign affiliates should take care to ensure compliance with the requirements of section 1441
- The IRS is making a concerted effort to verify that taxpayers are complying with the requirements of Form W8-BEN, "Certificate of Foreign Status of Beneficial Owner for United States Withholding"
- The IRS is requesting such forms during audit, then comparing the taxpayer's records to records obtained from vendors, to determine whether the taxpayer has complied with its reporting obligations

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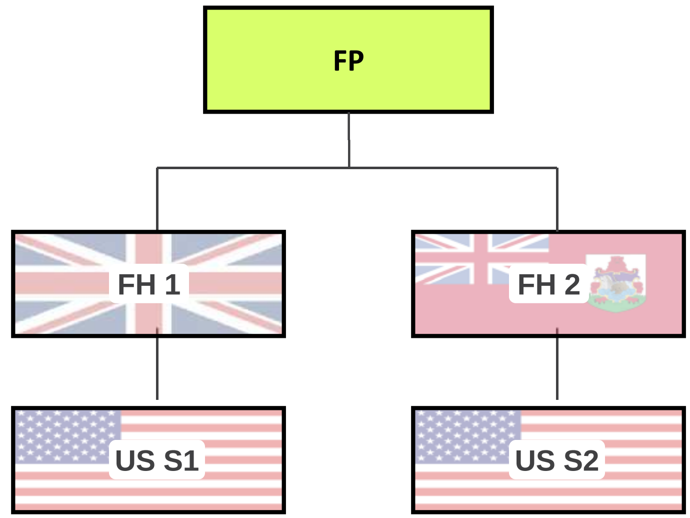
Complications with Applying Treaties To § 304

Example:

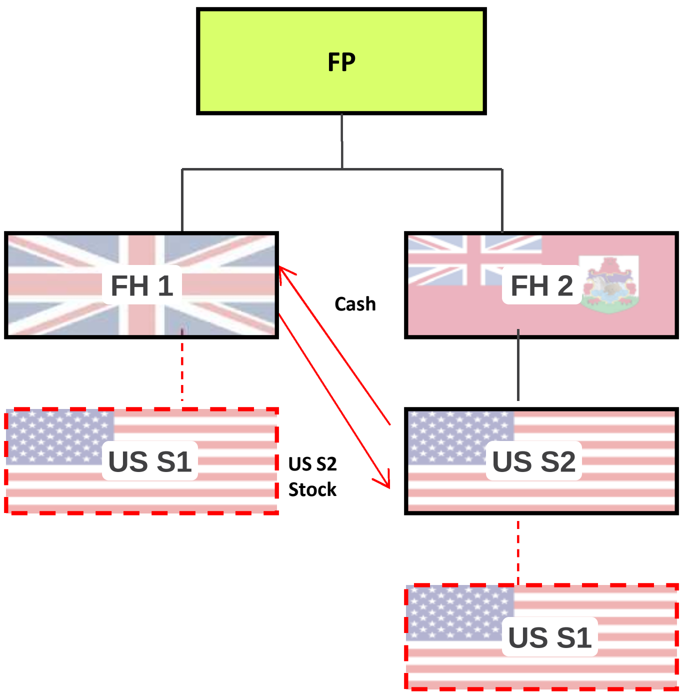
- Foreign parent controls a foreign holding company (FH 1) in the UK and a foreign holding company (FH 2) in Bermuda.
  - Under the U.S.-UK treaty, dividends are generally subject to 5% withholding if the owner owns at least 10% of the payor.
  - There is no U.S. treaty with Bermuda.
- FH 1 and FH 2 each control U.S. subsidiaries (US S1 and US S2).



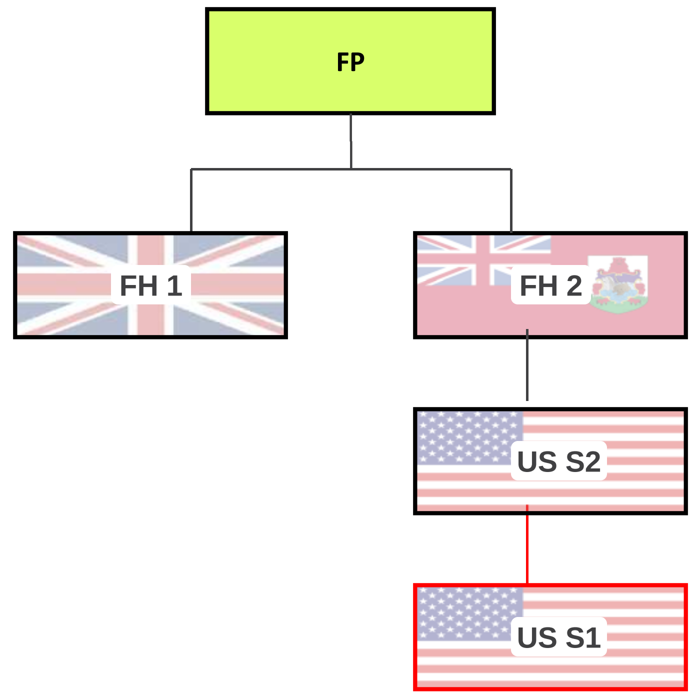
Complications with Applying Treaties To § 304 (cont'd)

Example (cont'd)

FH 1 sells US S1 to US S2 for cash



Ending Structure



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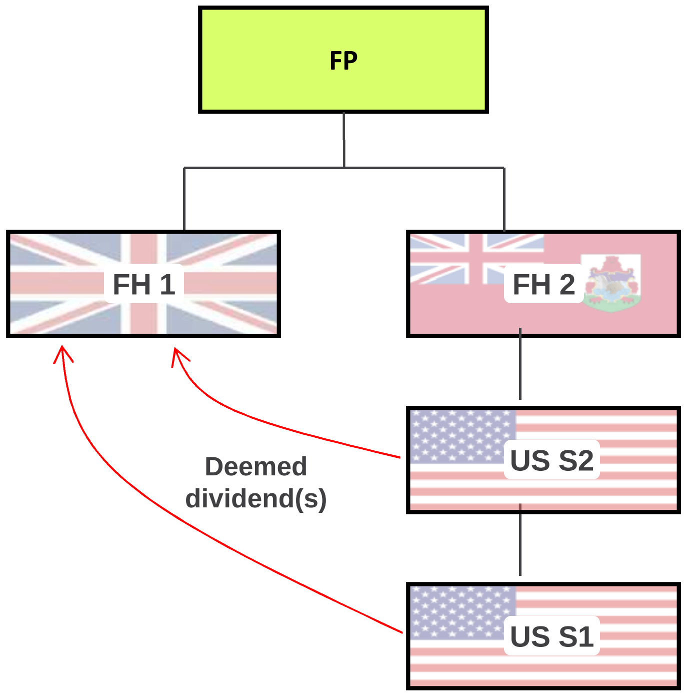
Complications with Applying Treaties To § 304 (cont'd)

Example (cont'd)

- Before the sale, FH 1 directly controlled US S1 by its direct ownership of US S1 stock, and it also controlled US S2 by operation of the attribution rule of § 318(a)(3)(C).
- Because FH 1 controlled both FH 1 controlled both US S1 and US S2, the sale of the US S1 stock is a transaction described in § 304(a)(1).
- The cash received by FH 1 is treated as a distribution in redemption of the US S2 stock.
- The distribution is treated as a dividend under §§ 301(c)(1) and 316.
- Under § 304(b)(2),
  - US S2 is deemed to pay a dividend to FH 1 to the extent of its E&P; thereafter,
  - US S1 is deemed to pay a dividend to FH 1 to the extent of its E&P.



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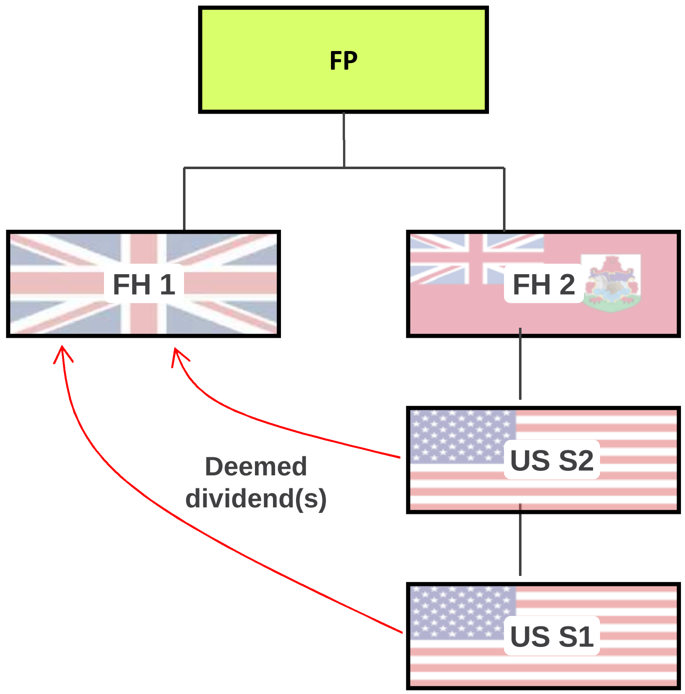
Complications with Applying Treaties To § 304 (cont'd)

Example (cont'd)

- §§ 861(a)(1) and (2) impose a tax of 30% on the amount of dividends paid by domestic corporations.
- This raises several issues:
  - Does the U.S.-U.K. treaty apply?
  - Assuming the U.S.-U.K. treaty applies, to the extent that US S2 is deemed to pay a dividend to FH 1, does the U.S.-U.K. treaty apply, even though FH 1 never owned US S2 stock?
  - To the extent that US S1 is deemed to pay a dividend to FH 1, does the U.S.-U.K. treaty apply, even though FH 1 no longer owns US S1 at the time of the deemed distribution?
  - If the U.S.-U.K. treaty does apply, what is FH 1's holding period in either US S1 or US S2?



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Complications with Applying Treaties To § 304 (cont'd)

- Treatment of the Dividend Deemed Paid by Acquirer (US S2):
  - In Rev. Rul. 92-85, the IRS held that the § 304 characterized dividend in the deemed redemption from acquirer (U.S.) to transferor (Country Z), while acquirer was only ever held by parent (Country A), met the applicable country U.S.-Country Z treaty, even though transferor did not actually own any acquirer stock, much less the 10% required under the treaty.
    - The applicable treaty language was "paid by a domestic corporation to a foreign corporation that owns at least 10% of the voting stock of the paying corporation."
  - Therefore, in the prior example, the U.S.-U.K. would be the relevant treaty with respect to the dividend deemed paid by US S2.
  - An analysis of the treaty language is necessary, but Rev. Rul. 92-85 lends some support that FH1 should be considered to own stock US S2 under certain treaty ownership requirements.
  - Holding Period?
  - Direct requirement?

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Complications with Applying Treaties To § 304 (cont'd)

- Treatment of the Dividend Deemed Paid by Issuer (US S1):
  - In Rev. Rul. 92-85, the IRS further held that, in a second scenario, the § 304 characterized dividend in the deemed redemption from issuer (U.S.) to transferor (Country C) was not subject to a reduced withholding rate, because there was no income tax treaty between the U.S. and Country C.
  - Therefore, in the prior example, the U.S.-U.K. would again be the relevant treaty with respect to US S1 as well.
  - An analysis of the treaty language is necessary, but Rev. Rul. 92-85 lends some support that FH1 should be considered to own stock of US S1 under certain treaty ownership requirements.
  - Holding Period?
  - Direct requirement?

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Alternatives To Avoid § 304

- Alternative I: Transfer the U.S. target in a § 368(a)(1)(D) reorganization.
  - The purchase price is only treated as a dividend to the extent of gain on the transferred shares (amount realized over basis).
  - Sourcing of dividend ordering rules differs from § 304.
- Alternative II: If U.S. acquirer is not a corporation.
  - § 304 only applies where acquirer is a corporation.
- Alternative III: E&P Blockers (prior law).
  - Form an intermediary without E&P as acquirer and/or issuer to reduce or eliminate any dividend amount.

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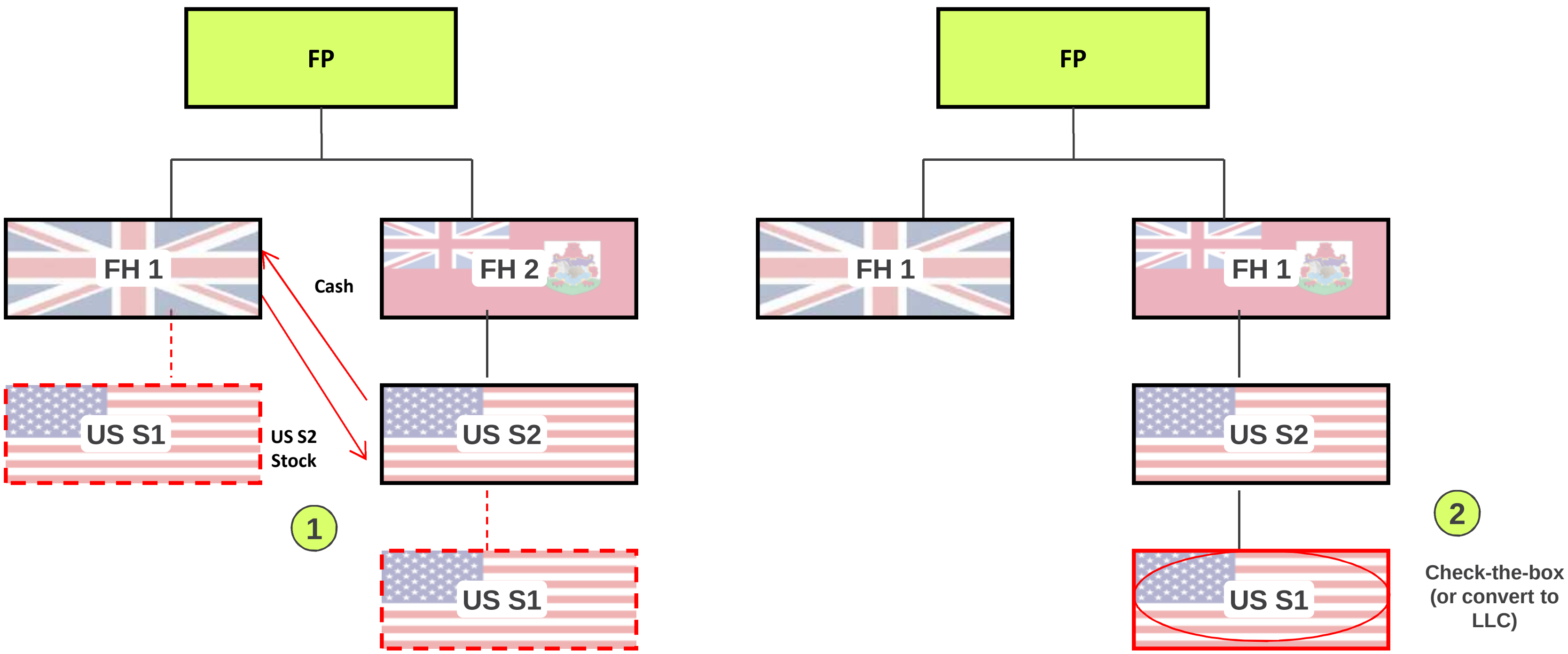
Alternative I To Avoid § 304: "D" Reorganization

- U.S. issuing corporation liquidates after the related party stock sale via check-the-box or conversion to LLC.
- For U.S. tax purposes, Steps 1 and 2 are intended to qualify as a § 368(a)(1)(D) reorganization.



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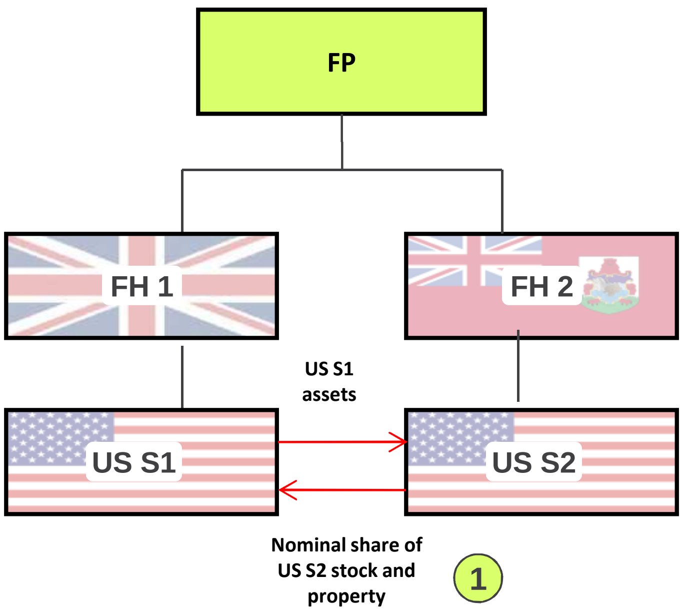
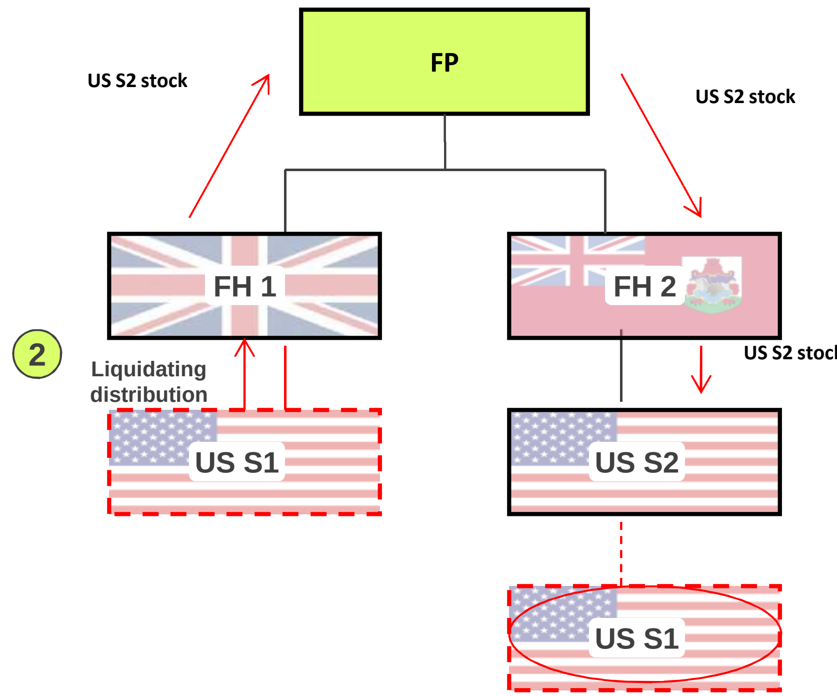
Alternative I To Avoid § 304: "D" Reorganization (cont'd)

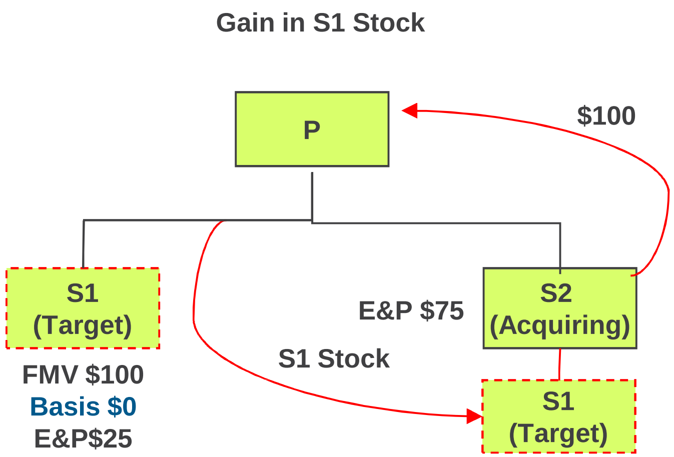
- First, US S1 is deemed to exchange all of its assets and liabilities to US S2 in exchange for property equal to the fair market value of US S1 and a nominal share of US S2 stock.
- Second, US S1 is deemed to distribute the stock and other property to FH 1 in a liquidating distribution. FH is deemed to distribute the nominal share of US S2 stock to FP, which is deemed to contribute it down to US S2.





Alternative I To Avoid § 304: "D" Reorganization (cont'd)

- Illustration of dividend within built-in gain rule
- "Cash D" with Gain



– In this example, P would have gain of $100 in the transaction. Generally, that gain is subject to characterization as a dividend (subject to U.S. withholding tax) to the extent of S1's and S2's current and/or accumulated E&P.

– Unfortunately, whether one only looks at S1's E&P or both S1's and S2's E&P is unclear.

– The Service stated that the E&P of *both S1 and S2* are combined for determining the dividend amount from the boot. Rev. Rul. 70-240; see also Davant v. Comm'r, 366 F.2d 874 (5th Cir. 1966).

– Currently, taxpayers often take the position that only the E&P of S1 is relevant based on American Mfg. Co. v. Comm'r, 55 T.C. 204 (1970), and Atlas Tool Co. v. Comm'r, 70 T.C. 86 (1978), aff'd 614 F.2d 860 (3d Cir. 1980).

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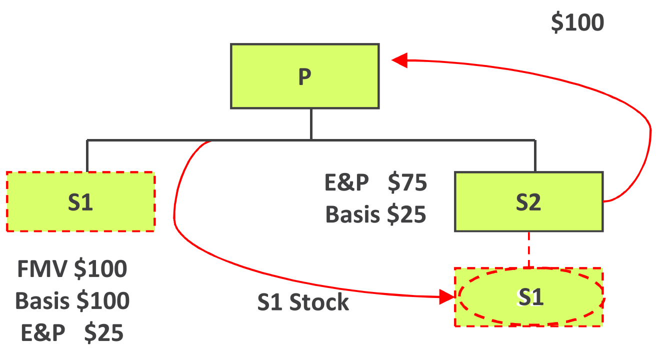
Alternative I To Avoid § 304: "D" Reorganization (cont'd)

- Illustration of dividend within built-in gain rule
- "Cash D" with No Built-in Gain



– In this example, P sells its S1 stock to S2 for $100 and then, immediately following the sale, an election could be made to treat S1 as a disregarded entity for U.S. federal tax purposes. This election would result in a deemed liquidation of S1.

– As discussed earlier, the sale of the S1 stock, followed by S1's liquidation, should be treated as a reorganization under § 368(a)(1)(D).

– Under § 356(a)(1), P would recognize any gain inherent in the S1 shares to the extent of the boot received.

– Under § 356(a)(2), any gain recognized should be treated as a dividend to P to the extent of P's ratable share of the undistributed E&P of "the corporation."

– Here, because there is no gain inherent in the S1 shares, P has no deemed dividend on the receipt of the $100 from S2.

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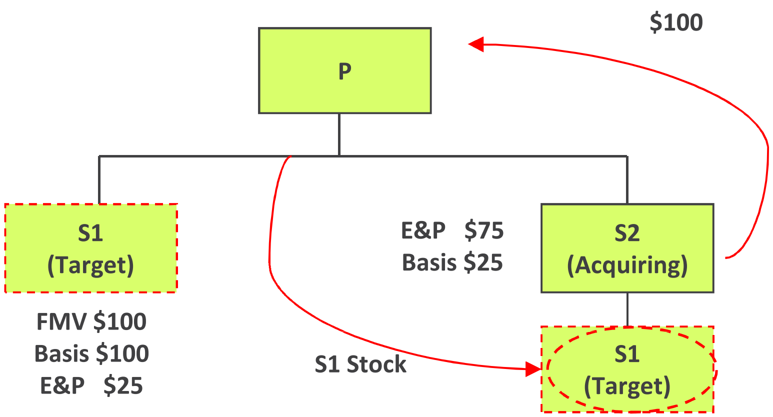
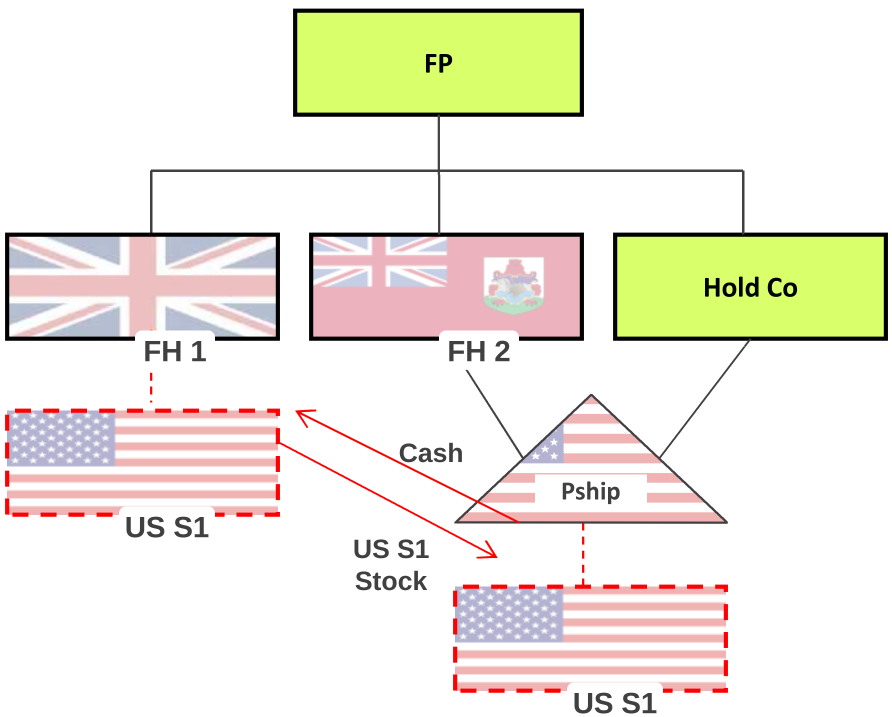
Alternative I To Avoid § 304: "D" Reorganization (cont'd)



- The Obama Administration's 2013 Budget Proposal would repeal the boot-within-gain limitation in the case of any reorganization if the exchange has the effect of a distribution of a dividend, as determined under § 356(a)(2).
- Pending legislation takes a slightly different tack and would amend § 356(a)(2) to state that "the amount of other property or money shall be treated as a dividend to the extent of the earnings and profits of the corporation," rather than limited by gain. H.R. 62, S. 1373.
- Additionally, the proposed legislation clarifies that the earnings and profits of each corporation in a "D" reorganization will be included in determining whether the distribution is a dividend under § 356(a)(2), and the amount that is treated as a dividend "shall be determined under rules similar to the rules of paragraphs (2) and (5) of § 304(b)."

Alternative II To Avoid § 304: Partnership As Acquirer



- FH 1 sells US S1 stock to an existing partnership owned by FH 2 and a holding company.
  - § 304 does not apply when the acquirer is not a corporation.
- Alternatively, US S2 could form a new partnership with Hold Co.
  - However, there is a risk that this could violate the partnership anti-abuse regulations (§ 1.701-2 rules).

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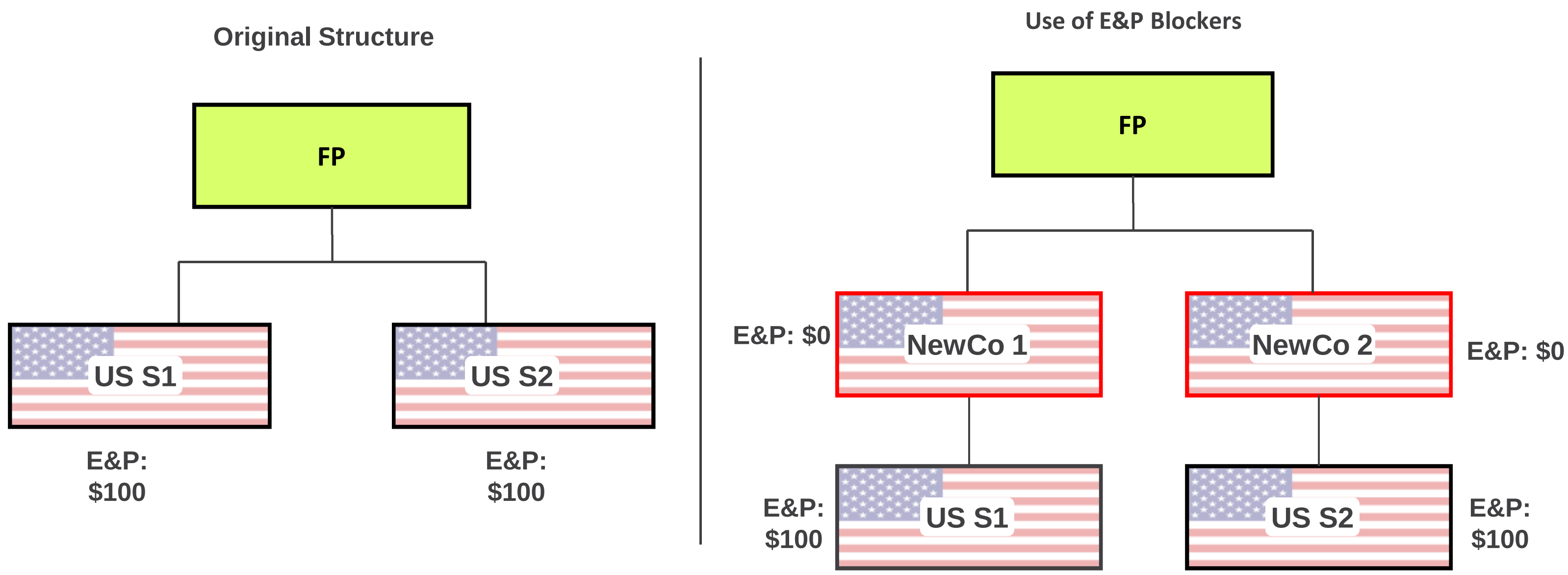
Prior Alternative III To Avoid § 304: New E&P Blockers



- Another potential solution was to insert NewCo E&P blockers over the issuing and acquiring corporations.
- However, this option is largely shut down due to the § 304 anti-abuse rule, which prevents the formation of a new corporation just to get around § 304.

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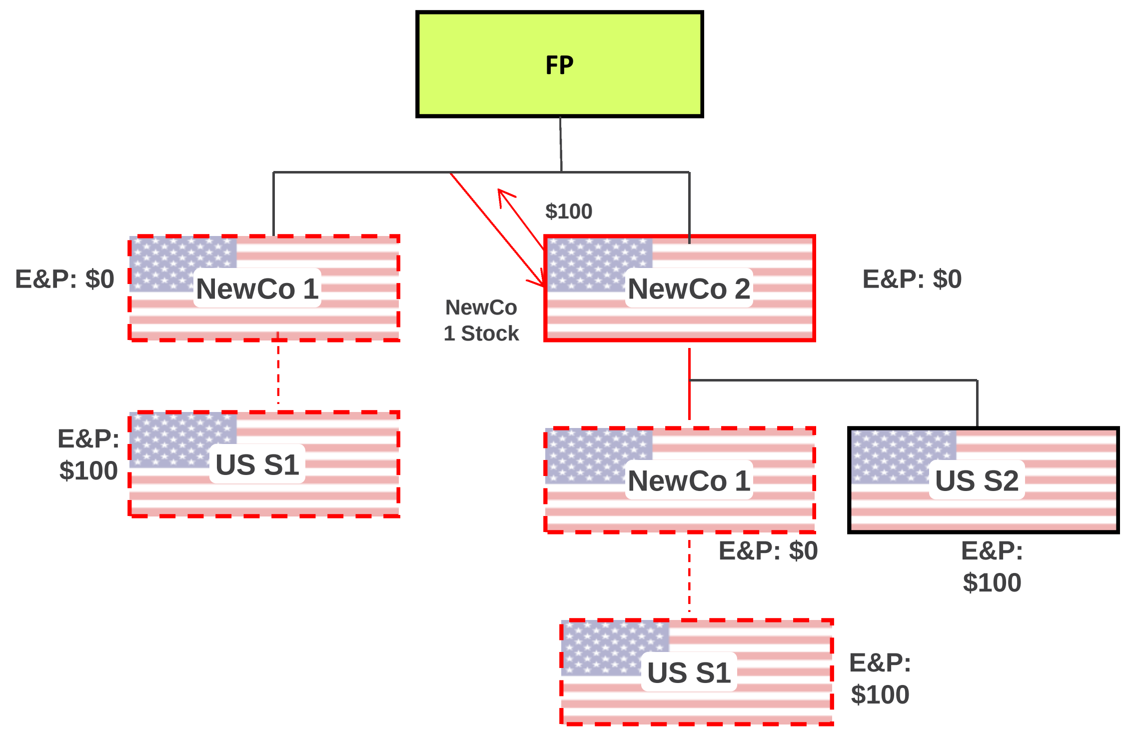
Prior Alternative III To Avoid § 304: New E&P Blockers (cont'd)

Example (cont'd)

- Absent the anti-abuse rule, FP would be deemed to receive a dividend from NewCo 2 to the extent of its E&P ($0), then from NewCo 1 to the extent of its E&P ($0). §§ 301(c)(1), 316, 304(b)(2).
- Because neither NewCo 2 nor NewCo 1 have E&P, the distribution would be treated as a sale or exchange.
- However, under Treas. Reg. § 1.304-4T, "if a principal purpose for creating, organizing, or funding" NewCo 1 is to avoid the application of § 304,US S1 will be treated as the "deemed issuing corporation" for purposes of applying § 304.

Use of E&P Blockers



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- § 304 Base Case
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- § 304 Trap for the Unwary: Application of § 367
- Alternatives To Avoid § 304
- § 304 Trap for the Unwary: FIRPTA

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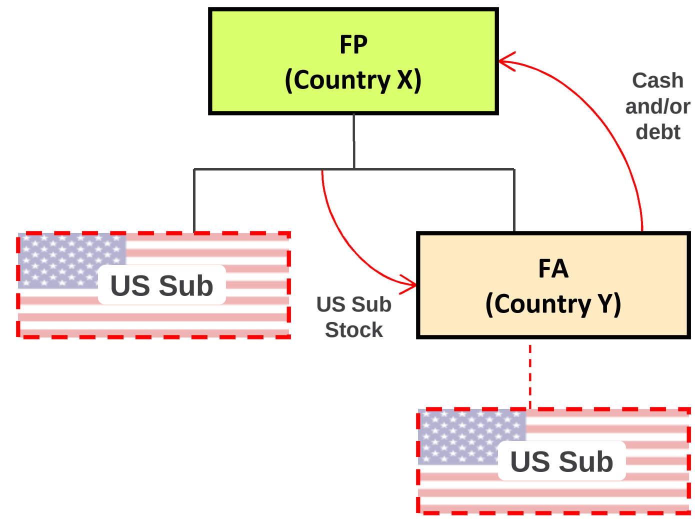
§ 304 Base Case

- Base Case Example:
  - FP, a Country X corporation, owns US Sub and FA, a Country Y corporation.
  - FP sells its stock in US Sub to FA for cash and/or debt.
- This is a trap for the unwary, because arguably there is no real abuse in the U.S.
  - This strategy is often used as part of worldwide planning to base erode Country Y's tax base through the use of debt as consideration.



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§ 304 Base Case (cont'd)

- Where acquiring corporation is foreign and the payment gives rise to a deemed dividend under § 304, § 304(b)(5)(A) modifies the E&P sourcing rules.
  - Generally, the U.S. corporation's E&P is treated as the source of the dividend.
  - The foreign acquiring corporation's E&P is only taken into account if:
    - The E&P is attributable to stock of the purchaser that is owned by the seller, or a person related to the seller, that is a U.S. shareholder of the purchaser; and
    - The E&P was accumulated while the purchaser was a CFC and the seller or related person owned the shares.

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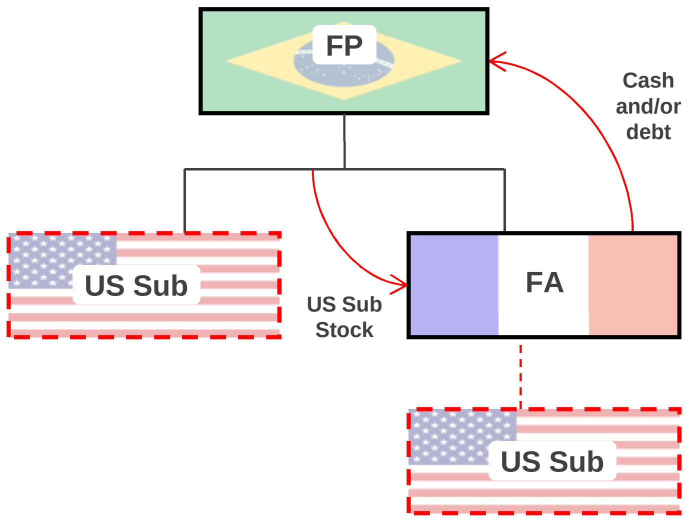
§ 304 Base Case (cont'd)

Example: Application of § 304(b)(5)(A)

- FP, a Brazilian corporation, owns US Sub and FA, a French corporation.
- FA acquires US Sub's stock from FP for cash and/or debt.
- Under the usual § 304 rules, FA would be deemed to pay a dividend to FP to the extent of its E&P, and then US Sub would be deemed to pay a dividend to FP to the extent of its E&P.
- However, under § 304(b)(5)(A), the dividend is deemed to be paid only from US Sub to FP to the extent of US Sub's E&P.
- Therefore, the purchase price will be subject to the U.S. withholding tax regime, as described above.



§ 304 Withholding Trap

- § 1441 requires withholding agents to withhold 30% of U.S. source FDAP income paid to foreign persons:
  - Withholding agents are persons having control, receipt, custody, disposal, or payment of any of the items of income that are subject to withholding.
  - In foreign-to-foreign transactions where the dividend is sourced from the U.S. Target's E&P, this creates confusion with respect to the withholding obligation— the foreign acquirer is the entity that actually makes the payment, but § 304 treats the distribution as being made by US Parent.
  - Rev. Rul. 92-85 provides that if the payor is a foreign person, it is the person in control of the payment and therefore the person required to withhold in the § 304 transaction. See also Rev. Rul. 80-362.

§ 304 Trap for the Unwary: Application of § 367

- § 367(a)(1) generally provides that, when a U.S. person transfers property to a foreign corporation in an exchange described in, *inter alia*, § 351, the foreign corporation is not treated as a corporation for purposes of determining the extent to which the U.S. person recognizes gain on the transfer.
- § 367(b)(1) similarly provides for potential income recognition for some non recognition exchanges (including § 351) in exchanges to which § 367(a)(1) does not apply.
  - § 367(b)(1) generally preserves the application of § 1248, which requires that, when a U.S. person that owns 10% or more of a CFC disposes of the stock of a CFC, the gain is recharacterized as dividend income to the extent of the E&P attributable to the stock.
- The IRS has interpreted a deemed § 351(a) exchange that occurs pursuant to § 304(a)(1) as an "exchange described in § 351" for purposes of § 367.

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§ 304 Trap for the Unwary: Application of § 367 (cont'd)

- Final regulations issued in 2006 provided that § 367(a) and (b) would not apply to § 351 exchanges deemed to occur by reason of § 304(a)(1). T.D. 9250.
  - Temporary regulations issued in 2009 provided an exception to this rule when a taxpayer reduces, under §301(c)(2), its basis in stock of the acquiring corporation beyond the stock deemed issued to the U.S. corporation in the deemed § 351 exchange.
- Notice 2012-15 changes this policy and provides that § 367 applies to a § 304 transaction, meaning that a Gain Recognition Agreement ("GRA") is required for the deemed § 351 transaction.
  - Notice 2012-15 also clarified that the deemed redemption of the foreign acquirer's stock would generally constitute a disposition under Treas. Reg. § 1.367(a)-8, and therefore would be treated as a triggering event.
  - However, the redemption will <u>not</u> be treated as a triggering event if the U.S. person enters into a new GRA that includes appropriate provisions to account for the redemption. Taxpayers can file a single GRA with respect to the entire § 304 transaction.
- If a taxpayer fails to enter a GRA or triggers the GRA, taxpayers could be taxed twice — once on the dividend distribution and once on the failed § 351 exchange.
- Notice 2012-15 is effective for transfers made on or after February 10, 2012.

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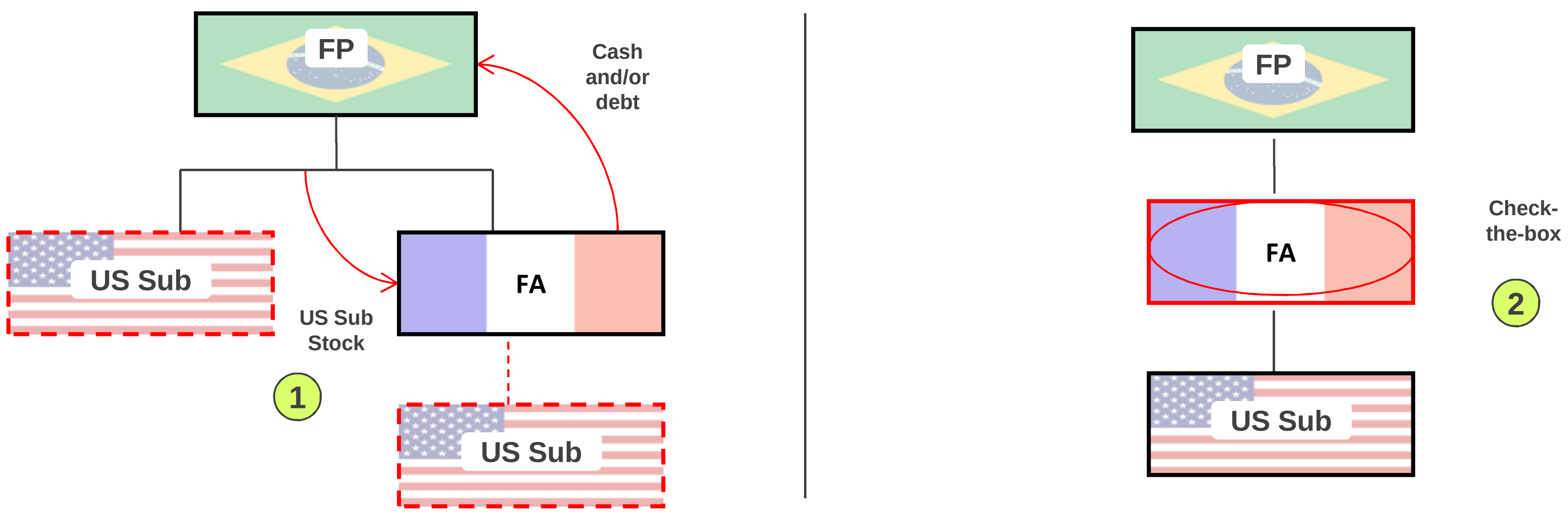
Alternative I To avoid § 304: Check-the-Box on Foreign Acquirer



- Check-the-box on the foreign acquirer to cause it to be treated as a Disregarded Entity for U.S. federal income tax purposes ("DRE").
  - If FA is directly held by FP, then "sale" never occurs, and § 304 does not apply.

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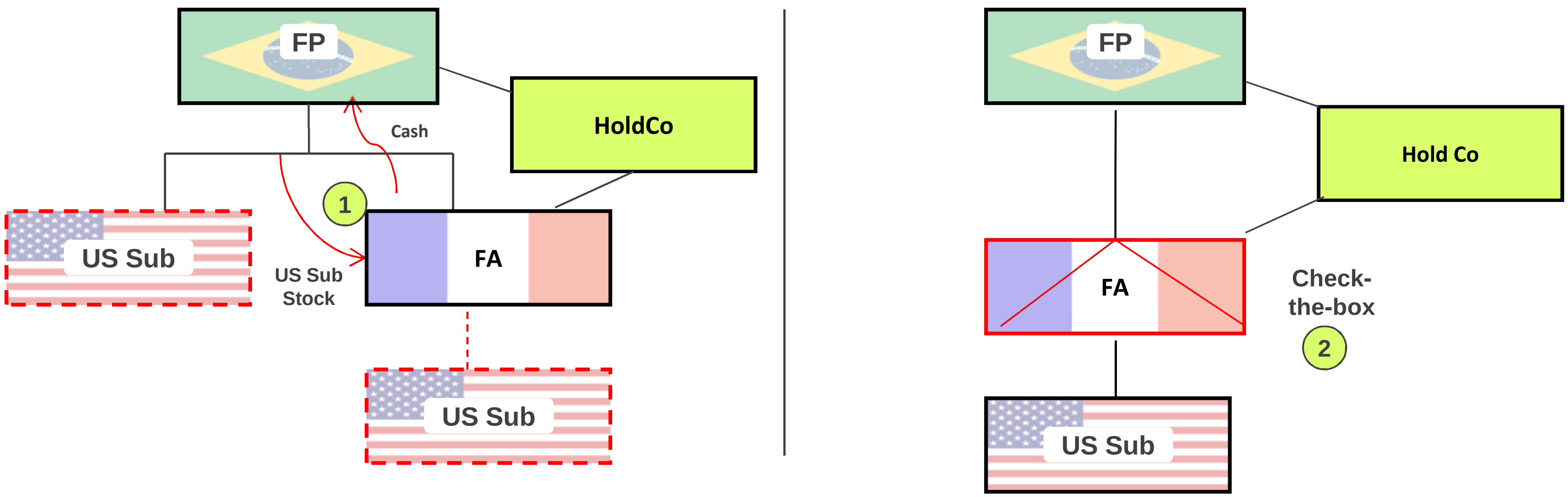
Alternative II To Avoid § 304: Check-the-Box on FA To Cause It To Be a Partnership



- Check-the-box on the foreign acquirer to be a partnership
  - Because FA is not a corporation, § 304 does not apply.
  - If Hold Co is not a pre-existing entity, do the § 1.701-2 anti-abuse rules apply to disregard the partnership formation?
  - Query whether it is anti-avoidance to avoid the application of § 304 when there is no abuse in the U.S.?

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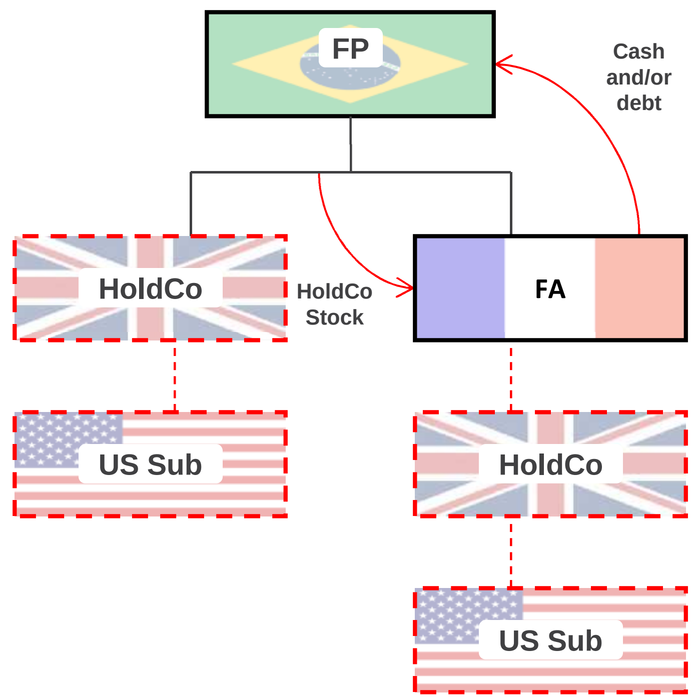
Alternative III To Avoid § 304: Sell Foreign Holding Company

- If there is a foreign holding company holding the U.S. target's stock, sell the stock of the holding company rather than the stock of the U.S. subsidiary.
- However, if there is not a foreign holding company already in existence, creating a new foreign holding company may trigger the § 304 anti-abuse rule.



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§ 304 Trap for the Unwary: FIRPTA

- Foreign Investment in Real Property Tax Act of 1980.
  - FIRPTA ensures that at least one level of U.S. income tax is charged on a foreign person's disposition of a U.S. real property interest ("USRPI") by classifying gain or loss from the disposition of a USRPI as income effectively connected with a U.S. trade or business ("ECI").
  - Prior to FIRPTA, foreign persons could also avoid U.S. taxation by selling stock in a U.S. corporation that held U.S. real estate.
- Gain or loss of a foreign person from disposition of a USRPI is treated as if the taxpayer were engaged in a trade or business within the U.S. ("USTB") in such year and the gain or loss is effectively connected with such USTB (i.e., as ECI).
  - Generally applicable rates apply (e.g., 15% rate for long-term capital gains of non-corporate sellers).
- As a result of ECI treatment, a foreign seller must file a U.S. tax return for the year of sale (e.g., Form 1120-F for foreign corporate seller).
- For foreign corporate sellers, branch profits tax may also apply on effectively connected earnings and profits ("ECEP"), except on the gain on the sale of U.S. Real Property Holding Company ("USRPHC") shares from ECEP.
- Treaty protection generally not available for gains from sale of U.S. real property.
- Withholding rules and special nonrecognition override rules may apply.

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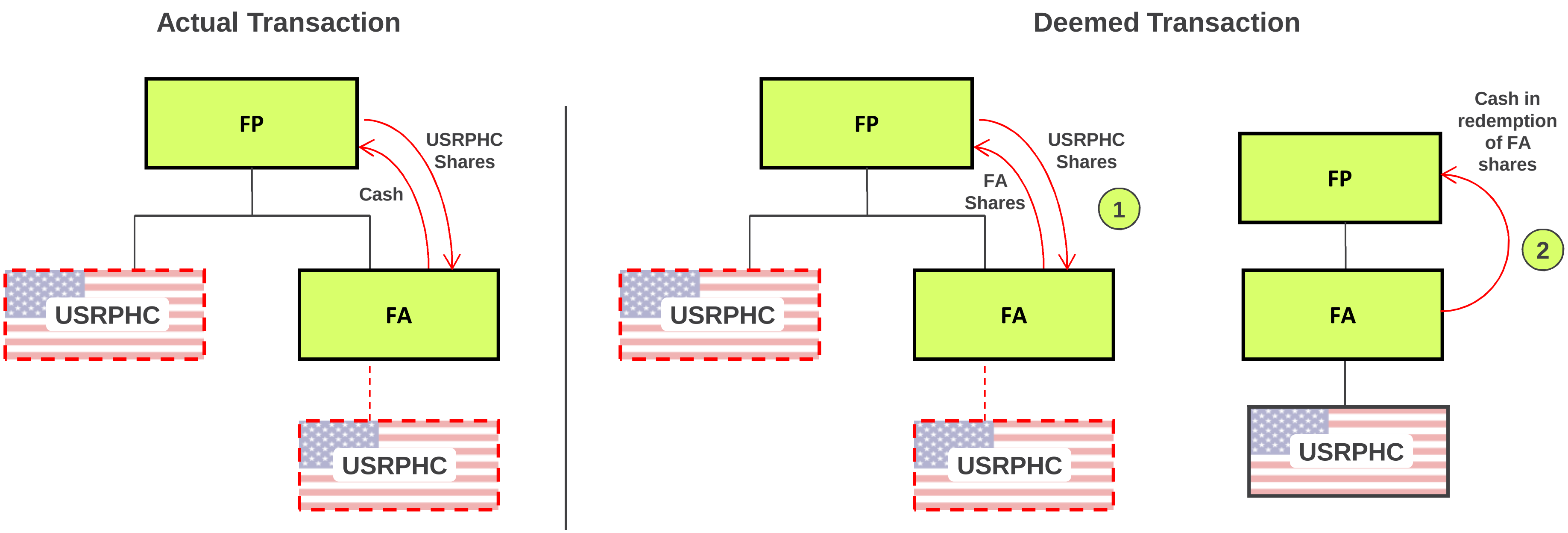
§ 304 Trap for the Unwary: FIRPTA (cont'd)

- Under § 1445(a), any transferee of a USRPI from a foreign person is required to withhold 10% of the amount realized (i.e., gross purchase price)
  - § 1445(e)(3): Distributions by certain U.S. corporations.
    - 10% withholding where a USPRHC makes a distribution to shareholders in a (i) redemption, (ii) liquidating distribution or (iii) § 301 distribution not out of E&P by a corporation.
    - § 1441 coordination rule (§ 1.1441-3(c)(4)) – USRPHC may either:
      - Withhold on full amount of distribution under § 1441 (i.e., 30% withholding, unless treaty reduction, but rate may not be less than 10%); or
      - Withhold under § 1441 on portion estimated to be a dividend and withhold under § 1445(e)(3) (i.e., 10%) on remainder (i.e., both basis recovery and sale or exchange gain) .
- Effect of withholding on transferor
  - Withholding does not discharge transferor's obligation to file U.S. tax return.
  - Amount withheld is credited against ultimate tax liability refunds may be claimed when return for year is ultimately filed.
  - Alternatively, taxpayers may apply for an "early refund" of over-withheld FIRPTA tax.
- Payment mechanics
  - Transferee must report and pay over withheld tax to IRS within 20 days after transfer date.
  - Transferee files Form 8288 and 8288-A. IRS returns a stamped copy of the 8288-A to the transferor (to establish amount of credit).

§ 304 Trap for the Unwary: FIRPTA

- FP sells USRPHC to related FA:



- Deemed 351 contribution:
  - Application of Treas. Reg. § 1.897-6T(b) FIRPTA exception to foreign-to-foreign exchange.
    - If stock in a USRPHC is transferred from a foreign corporation to a foreign corporation in a § 351 exchange and substantially all of the outstanding stock of the transferee corporation is owned by the former owners of the USRPHC, then FIRPTA gain will not be triggered on the exchange as long as:
      - Filing requirements are met, and
      - No **subsequent disposition** of exchanged stock (FA stock) within one year.

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§ 304 Trap for the Unwary: FIRPTA

- Deemed § 302 redemption of FA stock
  - Under sourcing rules described above, any deemed dividend is measured by USRPHC's E&P.
  - While unclear, it appears one could take the position that:
    - To the extent the redemption is treated as a dividend, there should be no "subsequent disposition" of the FA stock, thereby retaining the tax-free nature of the USRPHC stock transfer (though the dividend is subject to withholding, reduced by treaty, if any).
    - To the extent the redemption is treated as a redemption of the FA shares (*i.e.*, purchase price exceeds USRPHC's E&P) but does not exceed FP's basis in the FA shares received in the deemed exchange, there should be no "subsequent disposition" of the FA stock, thereby retaining the USRPHC stock transfer's tax-free nature.
    - To the extent the redemption exceeds USRPHC's E&P and FP's basis in the relevant FA shares (*i.e.*, the gain is capital gain), FP will trigger the "subsequent disposition," and the FP is required to recognize the portion of the gain realized with respect to the USRPHC stock for which the FA stock was disposed of was received.
      - In this situation, FP is taxed on FIRPTA gain relating to USRPHC stock transfer (for which FA should withhold 10%) and USRPHC's E&P (for which FA should withhold 30%, subject to a treaty-reduced rate).
      - Query whether withholding overlap rule of Treas. Reg. § 1.1441-3(c)(4), discussed above, is **ALSO** appropriate.

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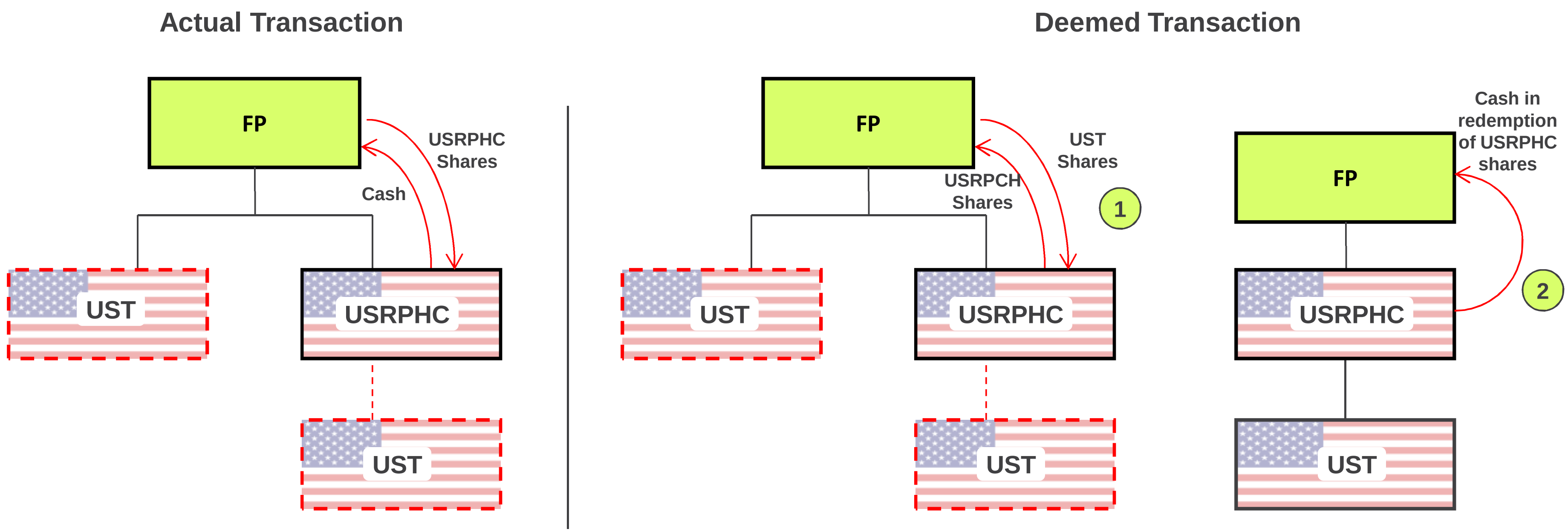
§ 304 Trap for the Unwary: FIRPTA

- FP sells UST to related USRPHC:



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§ 304 Trap for the Unwary: FIRPTA

- Deemed § 351 contribution:
  - FIRPTA is not applicable to the contribution of non-USRPHC in exchange for USRPHC stock.
- Deemed § 302 redemption of USRPHC stock:
  - Under sourcing rules described above, any deemed dividend is measured first by **USRPHC's E&P** and then by UST's E&P.
  - To the extent of **USRPHC's E&P**, Treas. Reg. § 1.1441-3(c)(4)'s overlap rule likely applies (described above).
  - To the extent of UST E&P, regular § 1441 withholding likely applies.
  - To the extent the deemed redemption is treated as a capital gain, Treas. Reg. § 1.1441-3(c)(4)'s overlap rule likely applies.

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SANDWICH STRUCTURES
NEW § 304(b)(5)(B)

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New § 304(b)(5)(B)
Transfer of U.S. Target To Foreign Acquirer

- New § 304(b)(5)(B) targets § 304 stock sales in the U.S. sandwich structure context that were intended to trigger deemed dividends from CFCs directly to the foreign parents that bypass the U.S. shareholder.
  - If you can drain the E&P from the CFCs, then the deferred earnings in the CFCs (§ 1248 Amount) are reduced.
- The new rule applies if more than 50% of dividends arising from a related party stock acquisition (§ 304 transaction) are (i) recharacterized as a redemption in which the acquiring corporation is a foreign person and (ii) would not be either:
  - Subject to U.S. tax in year in which the dividend arises, or
  - Includible in the E&P of a CFC.
- In other words, the rule would apply in cases where the deemed dividend skips over the U.S. entirely such that the acquiring corporation's earnings permanently escape the U.S. tax jurisdiction.
  - Effective date: acquisitions after the date of enactment, August 10, 2010.

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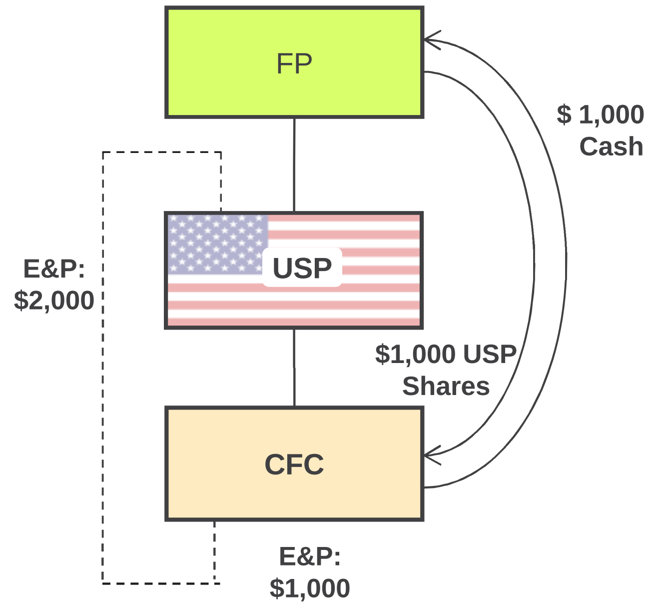
New § 304(b)(5)(B)
Transfer of U.S. Target To Foreign Acquirer (cont'd)

Example 1: Application of § 304(b)(5)(B)

- CFC purchases USP shares worth $1,000 from FP in exchange for $1,000 in cash.
- Old law: Under prior law, the purchase of USP shares by CFC from FP was recast under § 304 as a deemed dividend from CFC directly to FP of $1,000.
  - As a result, the repatriation of E&P from CFC to FP permanently escaped U.S.taxation.
  - While CFC's ownership of USP shares would have been treated as an investment in U.S. property under § 956 to the extent of CFC's E&P, following the purchase, CFC's E&P would likely be $0.
- New law: Now, under new § 304(b)(5)(B), the purchase of USP shares by CFC from FP skips over CFC's E&P and looks first (and only) at USP's E&P. As a result:
  - The $1,000 dividend from USP to FP is subject to the U.S.30% gross basis withholding tax (reduced by treaty).
  - CFC's ownership of USP shares is treated as an investment in U.S. property under § 956 to the extent of CFC's E&P of $1,000.



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Internal Transactions with Insolvent Companies

- Internal Liquidation with Insolvent Companies
- Internal Reorganizations with Insolvent Companies

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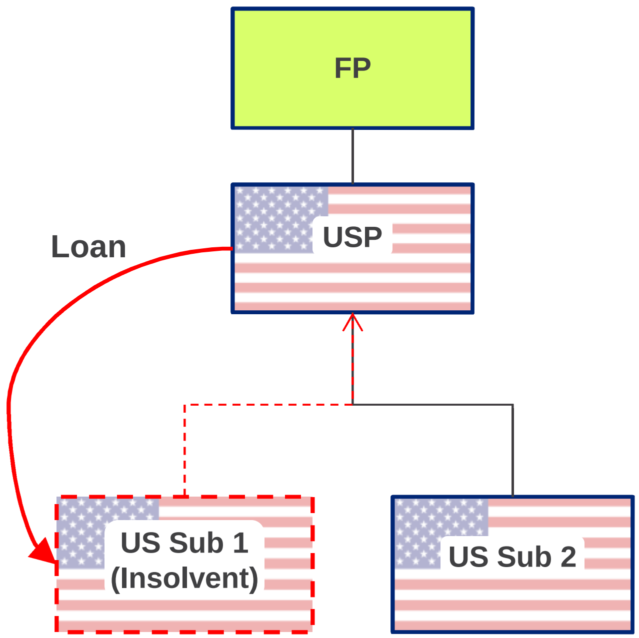
Internal Liquidation with Insolvent Companies



Liquidation of Insolvent Subsidiary:

- Net Operating Losses ("NOLs") and other tax attributes do not carry over to parent in liquidation.
- USP may be able to take a worthless stock deduction.
- US Sub 1 would recognize gain or loss on the liquidating transfer of its assets.
  - Losses on transfer to parent, however, are deferred.
  - If the assets are insufficient to repay liabilities, US Sub 1 would recognize cancellation of debt income.

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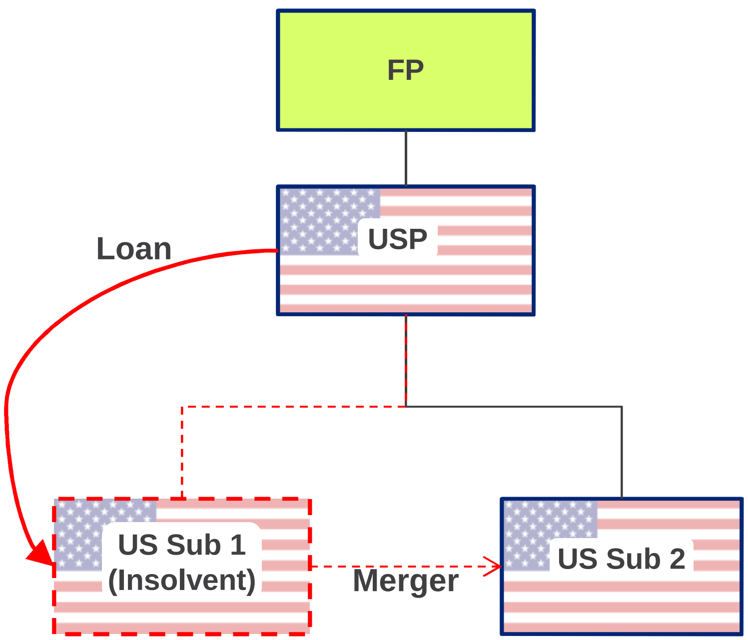
Internal Reorganizations with Insolvent Companies



- Proposed regulations under § 1.368-1(f) require an exchange of net value.
  - Value of assets acquired must exceed sum of liabilities assumed plus money and other non-stock property received.
- These proposed regulations do not apply to "E" or "F" type reorganizations or "D" reorganizations if the target corporation is solvent.
- Rev. Ruls. 78-330 and 2007-8 allow for cancelation or assumption of debt prior to a merger

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Internal Transactions: Defending Liquidations During Exam

- Although the IRS has taken something of a hands-off approach when looking into liquidation-reorganization issues, it is still important for companies to consider their approach to this area
- The Tax Court in *Olmstead v. Commissioner*, T.C. Memo. 1984-381, applied a three-prong test to determine whether a complete liquidation has taken place:
  - Was there a manifest intent to liquidate?
  - Was there a continuing purpose to terminate corporate affairs and dissolve?
  - Were the corporate activities directed and confined to that purpose?
- The Tax Court has held that the determination of whether a liquidation has occurred is a question of fact, *Pitts. Realty Inv. Trust v. Commissioner*, 67 T.C. 260 (1976)
  - Further, the IRS has issued extensive rulings in this area, particularly in the liquidation-reincorporation context

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Utilizing NOLs in Intragroup Reorganizations

- § 384 – Pre-Acquisition Loss Limitation
- § 384 – Issues To Consider

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§ 384 – Pre-Acquisition Loss Limitation

- §§ 382 and 383 are keyed to the acquisition of a loss corporation.
- § 384 generally applies to acquisitions by a corporation with NOLs, excess credits or capital losses.
- § 384 limits the use of certain tax attributes of one corporation (e.g., losses of an acquiring company) against certain recognized built-in gains ("BIGs")of another (e.g., BIGs of a target company).
  - In effect, § 384 attempts to limit "trafficking" in unrealized built-in gains.
  - § 384 denies the use of NOLs, excess credits and capital losses of the acquirer against certain gains recognized within a five-year Recognition Period following the acquisition of a target with BIGs.
  - § 384 applies both to acquisitions of stock and acquisitions of assets.
- In order for § 384 to apply, either the acquired, acquiring or surviving corporation must be a "gain corporation."
  - A gain corporation is a corporation with a net unrealized built-in gain (NUBIG) at the time of the acquisition.
  - § 384 prevents the other corporation from using its tax attributes to offset or reduce the tax on recognition of certain of those NUBIGs.

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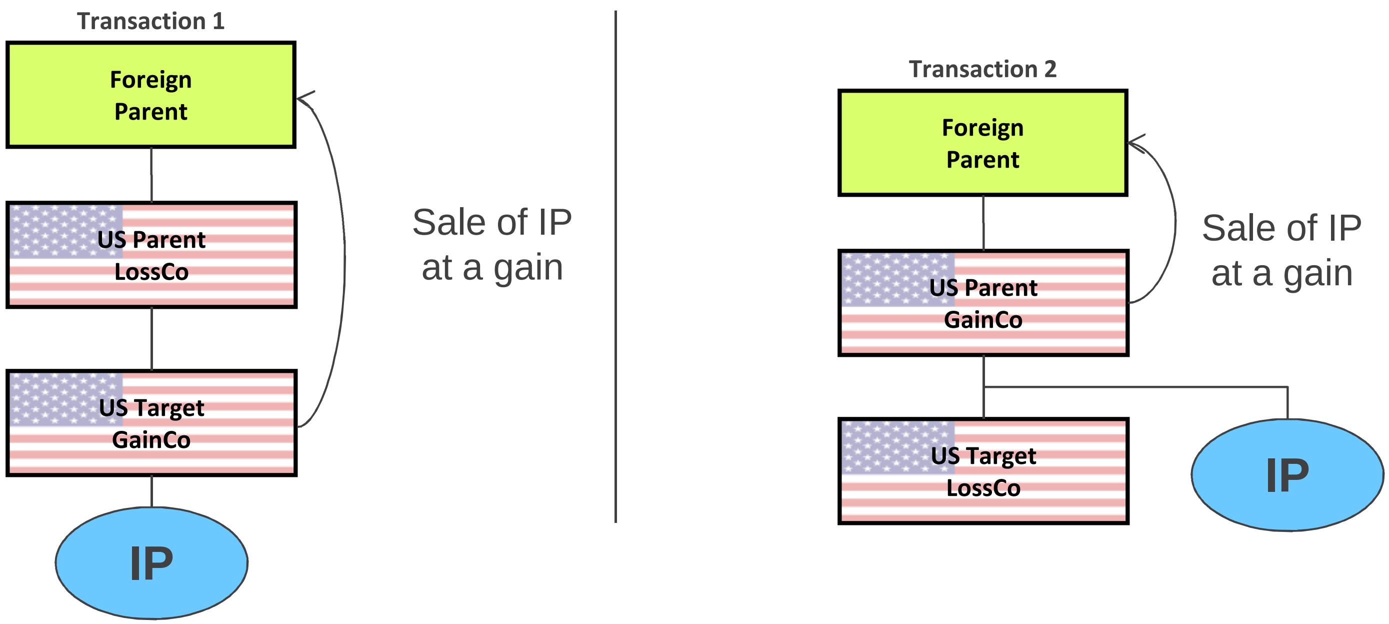
§ 384 – Pre-Acquisition Loss Limitation (cont'd)

- § 384 is applicable to each of the following transactions as the result of a stock or asset acquisition during the Recognition Period:
  - **Transaction 1** – US Parent's NOLs not available as an offset to the IP gain to the extent such gain is a Recognized Built-In Gain (RBIG).
  - **Transaction 2** – US Target's NOLs (available under § 382) are nonetheless not available to offset the IP gain to the extent the IP Gain is a RBIG.



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§ 384 –Issues To Consider

- The implications of § 384 should be carefully considered in any transaction in which the acquirer intends to dispose of appreciated target assets.
  - An appraisal of target's assets to be disposed of made at the time of the acquisition may be prudent.
  - If target assets are subsequently sold for a higher price than the appraisal, the appraisal may help to rebut an argument by the IRS that the higher value was "built-in" at the time of the acquisition.
- There is no guidance on whether Notice 2003-65 (safe harbor methods for calculating RBIGs) is applicable for measuring RBIGs for 384 purposes.
- Is there a consistency requirement if it is a § 382 event for LossCo and a § 384 event for GainCo?
- § 384(c)(7) provides that the § 384 limitation is applied to the predecessors and successors of an affected corporation.
  - This could be important in the event of a internal restructuring that occurs during the recognition period following a § 384 acquisition.
  - There are no regulations to describe how to apply the predecessor/successor rule.

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Will Carrying Back NOLs Give the IRS a Second Bite at the Apple?

- Taxpayers considering whether to carry NOLs back should consider whether such a decision will bring unwanted attention to a closed year
  - Typically, the Statute of Limitations on assessment is 3 years, unless an exception applies (i.e., 6 years if a taxpayer omits more than 25% of its gross income)
  - However, Section 6501(h) extends the statute of limitations if the deficiency is attributable to the disallowance of an NOL carryback
- Taxpayers may want to consider the potential risks that arise if they claim a large refund and end up before the Joint Committee on Taxation; carrying back an NOL might give prying eyes an extra opportunity to investigate their return
  - If the IRS missed something during audit, carrying an NOL back could lead to negative press and additional attention from the IRS during audits of open years

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Combining U.S. Groups

- Continuation of a Group
- Reverse Acquisitions
- Group Structure Changes

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Continuation of a Group
Treas. Reg. §1.1502-75(d)(1)

- A consolidated group remains in existence if:
  - Common parent remains as the common parent, and
  - At least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the current year.
- It is irrelevant whether one or more corporations became or ceased to be subsidiaries after the group was formed.

Reverse Acquisitions
Treas. Reg. § 1.1502-75(d)(3)

- Purpose of Provision:
  - Generally treats the larger group as the acquiring corporation, regardless of the form of the acquisition, and prevents transactions from breaking group.
  - Overrides the § 381 provisions that permit the form of an acquisition to control by treating the surviving corporation as the acquiring corporation.
  - Precludes a small group with attribute carryovers from acquiring a large group and using its attributes against the income of the large group.
- May be beneficial or detrimental depending on such factors as which group has NOLs or built-in losses.

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Reverse Acquisitions (cont'd)
Treas. Reg. § 1.1502-75(d)(3)

- Definitional requirements:
  - If a corporation ("first corporation" or "acquiring corporation")

    acquires

    - the stock, or
    - substantially all of the assets of another corporation ("second corporation" or the "target corporation")

    in a taxable or nontaxable transaction, and
  - as a result of the acquiring corporation's ownership in the target corporation, shareholders of the target corporation own more than 50% of the stock of the acquiring corporation.
- Which company was "bigger"?

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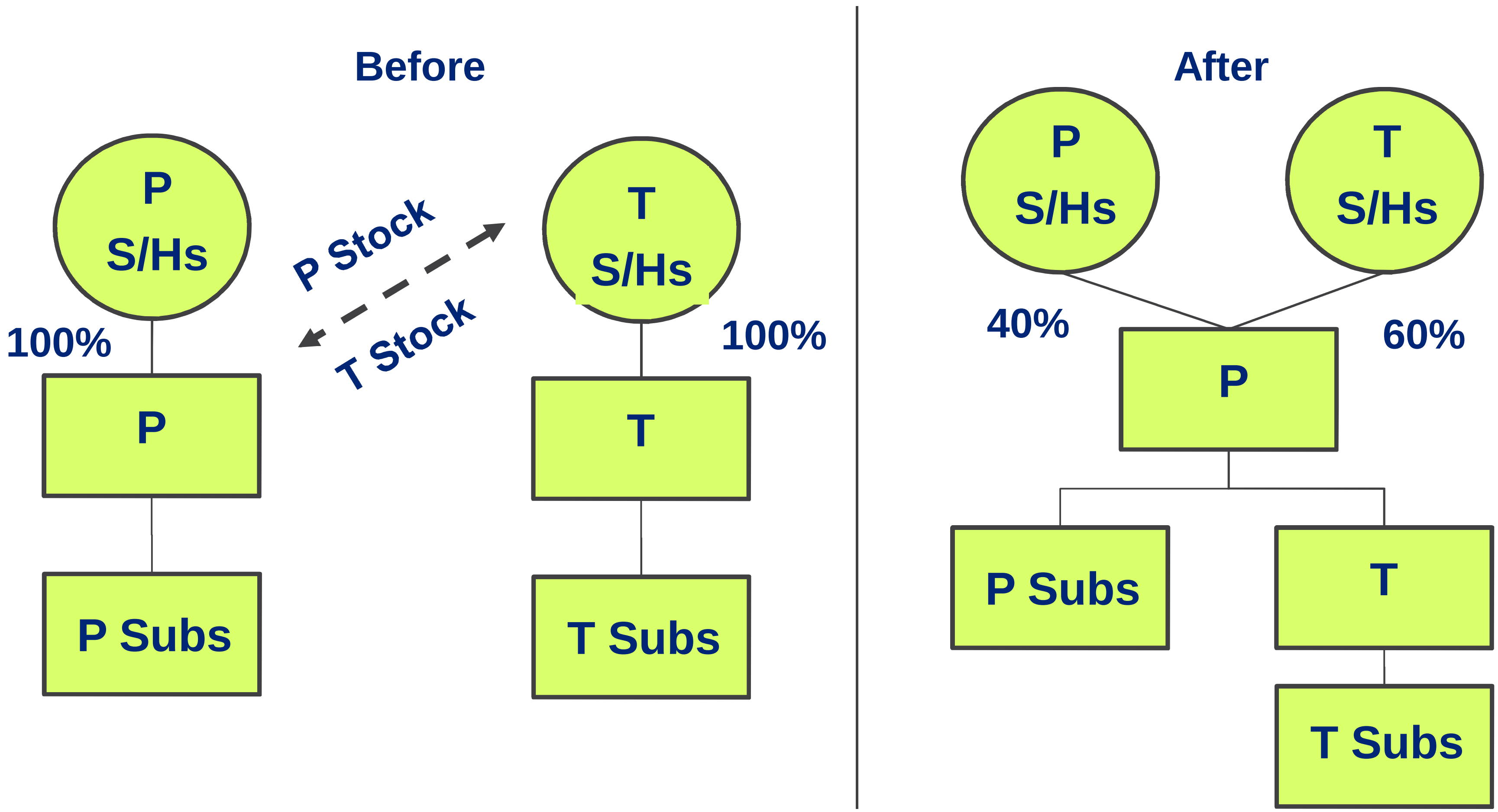
Reverse Acquisition Example



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Reverse Acquisitions
Treas. Reg. § 1.1502-75(d)(3)

- Certain federal income tax consequences of a reverse acquisition:
  - Acquiring corporation's group goes out of existence.
  - Acquiring corporation's group must close its taxable year and change to the taxable year of the Target corporation.
  - Acquiring corporation's NOLs may be limited.
  - Acquiring corporation's NOLs may be subject to Separate Return Limitation Year (“SRLY”).
  - Potential triggering of Excess Loss Accounts ("ELAs") and Defered Intercompany Transactions ("DITs"), but certain exceptions may apply.
  - E&P and stock basis adjustments (see Group Structure Changes, below).

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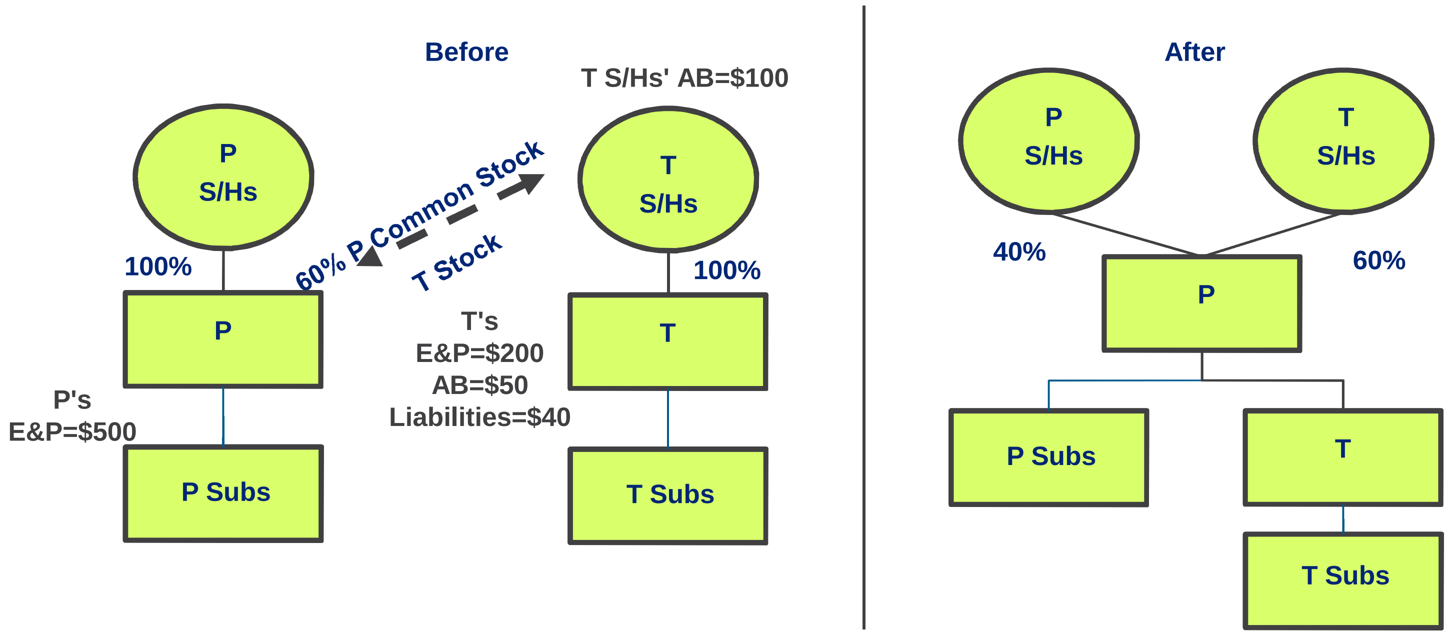
Group Structure Changes
Treas. Reg. §§ 1.1502-33(f) and -31

- Definition of "Group Structure Change":
  - If New Parent (P) succeeds another corporation as the common parent under "principles" of Treas. Reg. § 1.1502-75(d)(2) or (3).
- Consequences of Group Structure Change:
  - E&P:
    - In general, the E&P of P is adjusted to reflect the E&P of the former common parent.
    - Adjustment occurs immediately after P becomes the new common parent.
    - Treated as if P succeeds to the E&P of the former common parent in a transaction described in § 381(a).
  - Stock Basis:
    - In general, P's basis in the former common parent is adjusted to reflect the net inside asset basis of the former common parent.
    - Basis adjustments in subsidiaries may be necessary as well under § 1.1502-31.

Group Structure Change
Treas. Reg. § 1.1502-31 and -33(f) Stock Reorganization



- Assume the transaction qualifies as a B reorganization.
- What is P's basis in T?
  - Net inside basis of T, so $10. (AB $50 – Liabilities $40).
- What is P's E&P immediately after the transaction?
  - Will be adjusted to reflect T's E&P, so $700.

Combining US Groups – Potential Pitfalls When Lacking Business Purpose

- Taxpayers should make sure to establish a business purpose for certain internal restructurings
  - Section 368: Treas. Reg. 1.368-1(b) imposes a business purpose requirement on certain transactions occurring under section 368
  - Section 351: Section 351 does not explicitly require a business purpose, but the IRS does seek to determine whether a business purpose exists for certain transactions
- Typically, the bar is set low for establishing a business purpose
  - Taxpayers that have established business reasons for a transaction should make sure to document them; a failure to do so could open a transaction up to challenge
  - Taxpayers should also take care to follow through on the post-closing “clean-up” tasks that must be done to complete internal reorganizations

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Inversions

- Introduction
- Stock Inversions
- Asset Inversions
- Drop Down Transactions
- Moving Executives/Management Activities
- Virtual Headquarter Issues

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Inversions

- When a foreign acquirer (FA) acquires a U.S. Parent (USP), § 7874 may apply depending on the relative size of the USP compared to the FA.
- § 7874 was enacted in 2004, because § 367 (shareholder gain) rules were not enough of an obstacle to inversions, due in part to market conditions.
- § 7874 can apply to either stock or asset transfer forms of acquisition, but it is much more common for stock transactions.
- Application of § 7874 can produce one of three basic consequences at the corporate level:
    1. No adverse consequence;
    2. Limit former U.S. parent's (USP) use of tax attributes as a subsidiary of the foreign acquirer (FA); or
    3. Treat FA as a U.S. corporation for U.S. tax purposes (thus, negating the migration).
- The result among these outcomes depends on application of three key requirements of § 7874 (discussed on the next slides; each must be satisfied).
    – New final, temporary and proposed regulations on corporate inversions were issued on June 7, 2012.

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Inversions (cont'd)

First Test: Shareholder Continuity Test

- Percentage of FA stock owned by former USP shareholders after the transaction.
  - If less than 60%, then § 7874 is not applicable.
  - If 60% or more but less than 80%, then FA remains a foreign corporation for U.S. tax purposes, but limits use of attributes on inversion gain subject to U.S. tax. § 7874(a)(1) and (2)(B)(ii).
  - If 80% or more, if other requirements met, FA could be treated as a U.S. corporation for U.S. tax purposes. § 7874(b).
    - **Stock of insolvent domestic corporation *(clarification*):** The final regulations confirm that, if immediately prior to the first date that properties are acquired as part of an acquisition, a domestic corporation is in title 11 or similar case, then any claim by a creditor against the domestic corporation will be treated as stock of the domestic corporation.

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Inversions (cont'd)

Second Test: Substantially All Assets Test

- FA must acquire directly or indirectly "substantially all" the assets of USP for § 7874 to apply.
  - **Corporation's acquisition of own stock (*clarification*):** A acquisition by a foreign corporation of its stock from another corporation or partnership is an acquisition of the transferor's properties for purposes of § 7874(a)(2)(B)(i).
- The remaining slides will assume that the "substantially all" test is met in order to obtain tax-free treatment of the transaction.

Third Test: Substantial Business Activities Test

- The expanded affiliated group must not have substantial business activities in the applicable foreign country compared to the total business activities of the group for § 7874 to apply.

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Inversions (cont'd)

- § 7874 and Treas. Reg. § 1.367(a)-3(c) have been adopted to limit the tax benefits where a U.S. corporation is transferred to foreign corporation for which the former shareholders of the U.S. corporation have a stake in the foreign corporation.
- In a stock inversion,
  - § 7874 generally applies to the inverting corporation and its acquiror (*i.e.*, U.S. Parent and Foreign Parent), and
  - Treas. Reg. § 1.367(a)-3(c) generally applies to the U.S. shareholders of U.S. Parent.
- In an asset inversion,
  - Generally, both §§ 7874 and 367 may result in taxation of gain realized by U.S. Parent, the inverting corporation.

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Inversions

Update: Clarification re: Options § 7874(h)

- The final regulations clarify several issues concerning the treatment of options or similar interests (together, an "option").
- Claim-on-equity treatment under the temporary regulations is retained, with certain modifications.
- Valuation (*clarification*):
  - Retains the "claim of equity" standard, but notes that the value of an option (the value of holder's claim on the equity of the corporation) is reduced by the exercise price, but in no case is a claim on equity less than zero.
  - The value is reduced by property, which, pursuant to the option terms, the holder must deliver to the corporation (or partnership) in order to exercise the option.
- Voting Power analysis (*addition*):
  - *General rule*: Options are not taken into account for purposes of determining the voting power of stock under § 7874.
  - *Principal purpose exception*: An option will be treated as exercised if a principal purpose of the issuance or acquisition of the option is to avoid treating the foreign corporation as a "surrogate foreign corporation." § 7874(h)(2)

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Inversions

Update: Clarification re: Options § 7874(h) (cont'd)

- Effect of option on value of outstanding stock (*clarification*): The value of the stock of a foreign corporation will <u>not</u> be adjusted to reflect the value of options that are treated as exercised for purposes of § 7874.
- Expansion of option anti-abuse rules (§ 7874(h)(4)):
  - The anti-abuse rules state that an option will not be treated as exercised (and has no value) if either:
    - A principal purpose of the issuance or acquisition of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation, or
    - (*addition*) At the time of the acquisition, the probability of the option being exercised is remote.
  - *Addition*: The anti-abuse rules apply to options with respect to <u>all</u> corporations and partnerships, domestic or foreign.
- Expanded Affiliated Group analysis (*clarification*): The rules addressing options also apply for purposes of determining the membership of an expanded affiliated group under § 7874(c)(1).

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Types of Inversions

- Inversion transactions take the form of:
  - (1) A *“**stock transaction**"* – the most common format (*e.g.*, Helen of Troy, Triton Energy, Everest Reinsurance, Fruit of the Loom, Stanley Works);
  - (2) An "***asset transaction;***";
  - (3) A "***drop down transaction***"; and
  - (4) A "***out-from-under***" transaction.

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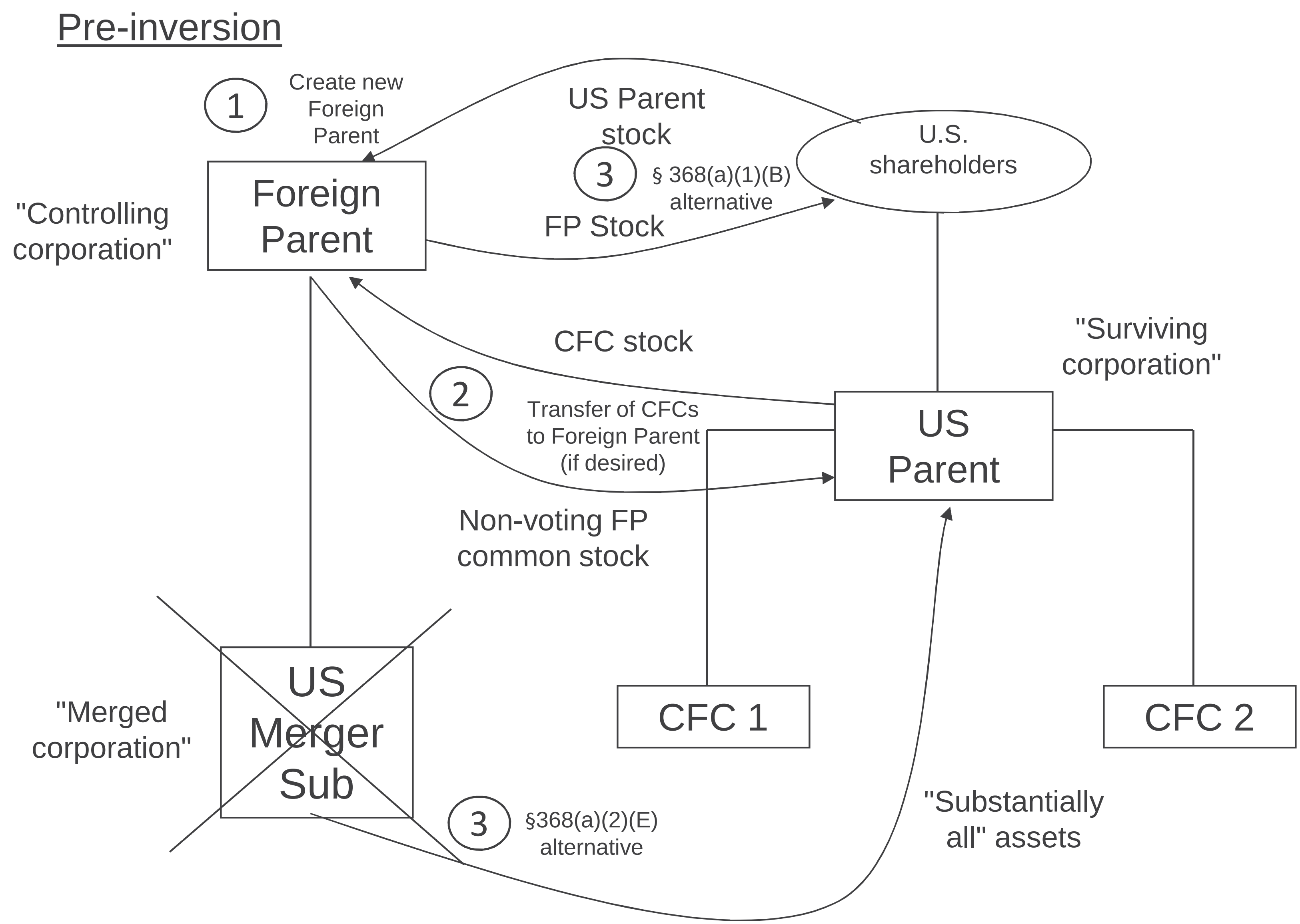
Stock Inversions

- Public shareholders of U.S. Parent exchange their stock for stock in Foreign Parent, a newly formed foreign holding company, either:
  - Directly (pursuant to § 368(a)(1)(B)) or
  - Through a reverse subsidiary merger (pursuant to § 368(a)(2)(E)) with U.S. Parent surviving as a subsidiary of Foreign Parent.
- U.S. Parent may transfer its foreign subsidiaries to Foreign Parent immediately before the inversion in a § 351(a) transaction in exchange for a second class of FA common stock that is non-voting but that carries dividend rights ("***hook stock***").
  - The exchange would not qualify as a § 368(a)(1)(B) reorganization, because the stock received by U.S. Parent is non-voting.

Stock Inversions – Single Company



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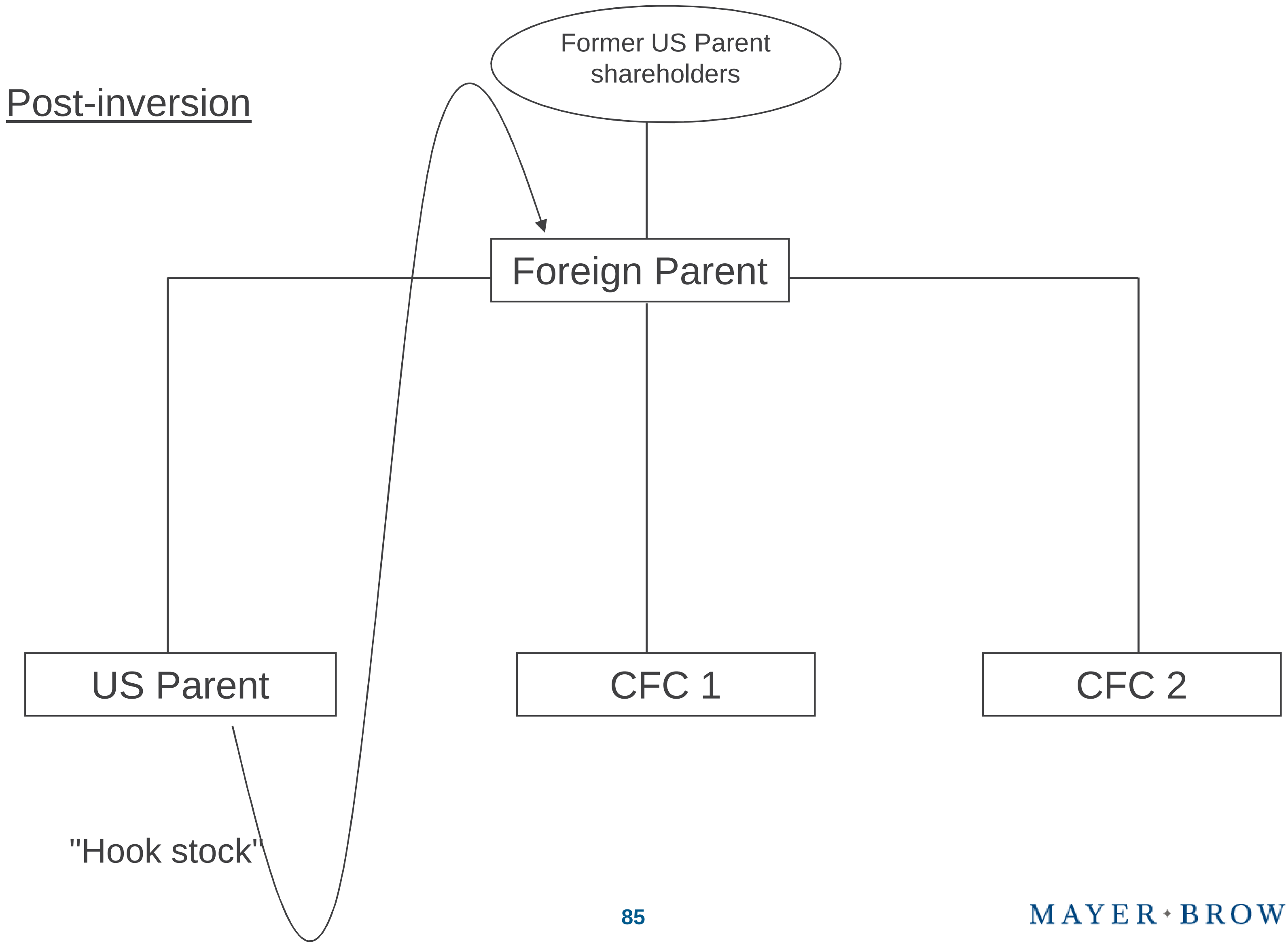
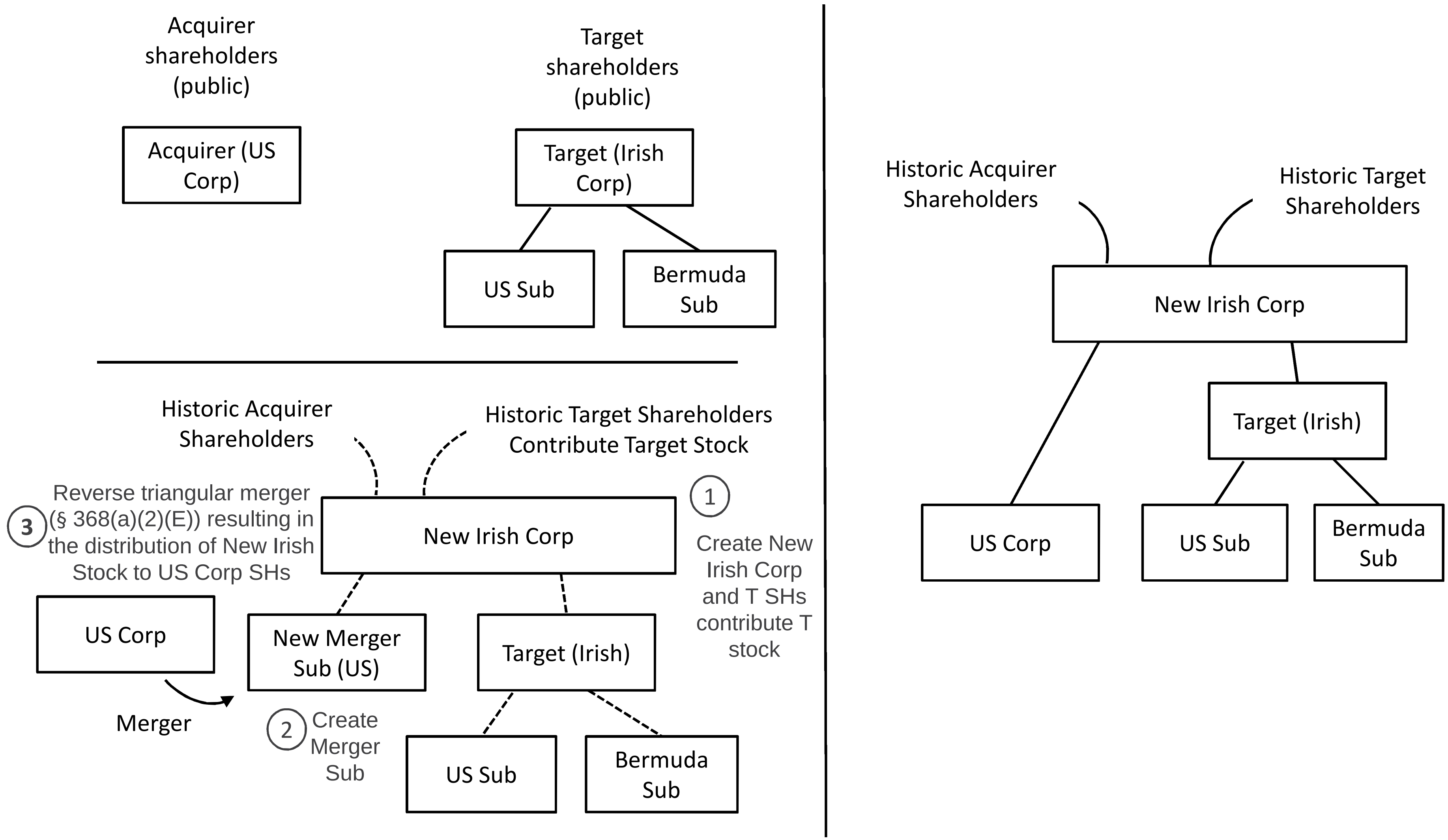
Stock Inversions – Single Company (cont'd)



Stock Inversion – With Existing Foreign Corporation



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Stock Inversions (cont'd)

- It might be useful to categorize the stock inversions into four categories based on the former U.S. Parent shareholders' stake in the Foreign Parent:
  - Less than 50% inversion.
  - 50-59.9% inversion.
  - 60-79.9% inversion.
  - 80% or greater inversion.
- There are certain special rules in counting the shareholder percentage of Foreign Parent under § 7874, such as:
  - The stock sold in a Foreign Parent IPO related to the acquisition is generally disregarded, and
  - Convertible debt instrument and options generally are considered exercised in testing ownership value.

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Less than 50% inversion

- Consequences for U.S. Parent:
  - § 7874 would not apply. § 7874(a)(2)(B)(ii).
  - U.S. Parent would be subject to tax under § 367 with respect to the transfer of the CFC stock unless it enters into a five-year GRA (§ 1.367(a)-3(a)).
  - If, after the transaction, the U.S. parent wishes to transfer stock in CFCs to Foreign Parent, § 367(b) (requiring inclusion of a "§ 1248 amount") may be implicated. *See* Treas. Reg. § 1.367(b)-4(b).

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Less than 50% inversion (cont'd)

- Consequences for U.S. Parent shareholders:
  - Treas. Reg. § 1.367(a)-3(c) generally would not deny non recognition treatment to gain realized by U.S. shareholders of U.S. Parent with respect to an otherwise tax-free inversion (e.g., under § 351 or 368), provided certain additional requirements are met.
  - On a transfer of U.S. Parent stock to Foreign Parent, there are four basic requirements in Treas. Reg. § 1.367(a)-3(c) to maintain otherwise nontaxable treatment to U.S. shareholders of U.S. Parent, all of which must be satisfied.
    1. Receive $\leq$ 50% of vote/value of Foreign Parent.
    2. "Insiders" have $\leq$ 50% of Foreign Parent (including previously held stock).
    3. U.S. transferor is either <5% or enters five year GRA.
    4. Active trade or business test:
       - 36-month active business in Foreign Parent.
       - Substantiality (relative size of U.S. Parent compared to Foreign Parent, *i.e.,* Foreign Parent must be equal or larger).

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Less than 50% inversion (cont'd)

- Consequences for U.S. Executives:
  - § 4985 would not apply
    - § 4985, discussed in greater detail below, generally imposes an excise tax on the stock-based compensation of an executive held within six months before or after the expatriation date.
  - § 457A would apply, which practically limits the ability of certain foreign corporations to provide deferred compensation (such as excess 401(k) plans and SERPs) to employees subject to U.S. tax.
    - § 457A provides that deferred compensation under a non-qualified compensation plan (including a plan that provides compensation based on stock appreciation rights) of a foreign corporation is included in gross income when there is no substantial risk of forfeiture of the rights to such compensation, rather than when it is actually paid.
    - § 457A does not apply if substantially all of the foreign corporation's income is either (1) effectively connected with a U.S. trade or business or (2) subject to a comprehensive foreign income tax.
    - Compensation shall not be treated as deferred if it is received within 12 months after the end of the foreign corporation's taxable year during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture.
    - Thus, deferred compensation of a non-qualified compensation plan (including a plan that provides compensation based on stock appreciation rights) from a foreign corporation generally becomes taxable to the employee when the rights to such compensation are no longer conditioned upon the future performance of substantial services by any individual.

50-59.9% inversion

- Consequences for U.S. Parent:
  - § 7874 would not apply.
  - The consequences with respect to the transfer of the CFC stock are generally the same, regardless of the interest of the U.S. Parent shareholders in the Foreign Parent.
- Consequences for U.S. Parent Shareholders:
  - If U.S. Parent shareholders receive more than 50% of the shares by vote or value of the Foreign Parent, the Treas. Reg. § 1.367(a)-3(c) requirements are not met; therefore, U.S. shareholders of U.S. Parent cannot receive tax-free treatment on the inversion.
- Consequences for U.S. Executives:
  - § 4985 would not apply.
    - § 4985, discussed in greater detail below, generally imposes an excise tax on the stock-based compensation of an executive within six months before or after the expatriation date.
  - § 457A would apply.
    - § 457A, discussed above, practically limits the ability of certain foreign corporations to provide deferred compensation (such as excess 401(k) plans and SERPs) to employees subject to U.S. tax.

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60-79.9% inversion

- Consequences for U.S. Parent:
  - § 7874 would apply.
  - Under § 7874, U.S. Parent is the "expatriated entity," and Foreign Parent is the "surrogate foreign corporation," unless the substantial business activities test is met.
  - § 7874(a)(1) provides that the expatriated entity's (the U.S. Parent's) taxable income shall not be less than its "inversion gain" (described on the next slides) during the "applicable period".
    - The "applicable period" begins on the first date properties are acquired as part of the acquisition and ends 10 years after the last date properties are acquired.

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60-79.9% inversion (cont'd)

- § 7874 does not cause items to be included in taxable income that would not otherwise be so included.
- Rather, § 7874 prevents the utilization of certain tax attributes to reduce the tax due with respect to those items that constitute **"inversion gain"** (defined on the next slide).
  - § 7874(e)(1) provides that the inversion gain cannot be offset by net operating losses or credits (other than foreign tax credits).
  - While the § 7874(e)(1) does not directly prohibit the use of foreign tax credits against inversion gain, such inversion gain is treated as U.S. source income for purposes of determining the entity's foreign tax credit limitation.
- Like AMT, the effect of § 7874(e) is to create a minimum amount of income that must be recognized.
  - § 7874(e)(3) also effectively provides that the U.S. parent's alternative minimum taxable income for the year shall not be less than its inversion gain.

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60-79.9% inversion (cont'd)

- "Inversion gain" is defined as:
  - The income or gain recognized during the applicable period by reason of the transfer of stock or other properties by an "**expatriated entity,**" and
  - Any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity:
    - As part of the acquisition resulting in the inversion, or
    - After such acquisition if the transfer or license is to a "**foreign related person"** (but not with respect to property described in § 1221(a)(1) (e.g., inventory) in the hands of the expatriated entity).
- The "expatriated entity" includes not only the U.S. Parent, but all related (within the meaning of § 267(b) or 707(b)(1)) domestic corporations or partnerships.
- A "foreign related person" means a foreign person that is related within the meaning of § 267(b) or 707(b)(1) (i.e., more than 50% control) or is under the same common control within the meaning of § 482.

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60-79.9% inversion (cont'd)

- While somewhat ambiguous in the statute, the legislative history makes relatively clear Congress's intent to include in inversion gain:
  - Any gain or income from the transfer of property (other than inventory and similar property) from a U.S. company to a related foreign company, and
  - Any income from licenses from a U.S. company to any related foreign company during the 10-year period, regardless of whether the transfer is made as part of the inversion.
  - "Specifically, any applicable corporate-level income or gain required to be recognized under §§ 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign corporation is taxable, without offset by any attributes (e.g., net operating losses or foreign tax credits)."
    - Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal JCS-2-10 8/16/2010.
  - This would include gain recognized on a transfer of CFC stock to a related foreign company either as part of (i) the inversion transaction within the 10-year period, or (ii) a § 1248 inclusion required by § 367(b) and Treas. Reg. § 1.367(b)-4(b) if the stock is transferred in a nonrecognition transfer.

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60-79.9% inversion (cont'd)

- Consequences for U.S. Parent Shareholders:
  - Because U.S. Parent shareholders receive more than 50% of the shares by vote or value of the Foreign Parent, the Treas. Reg. § 1.367(a)-3(c) requirements are not met; therefore, U.S. shareholders of U.S. Parent cannot receive tax-free treatment on the inversion.
- Consequences for U.S. Executives:
  - § 4985 would apply.
    - Generally imposes an excise tax at a rate equal to the maximum individual adjusted capital gain rate (*i.e.*, 20% after December, 31, 2012) on the value of certain stock options and other stock-based compensation held by or for the benefit of a certain officers, directors and 10%-or-greater owners at any time during the 12-month period beginning on the date that is six months before the expatriation date.
    - The excise tax applies to "specified stock compensation," meaning payment granted by the expatriated corporation (including any predecessor or successor or any member of the expanded affiliated group) to any person in connection with the performance of services by a "disqualified individual" if the value of such payment is based on the value of stock in such corporation.

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60-79.9% inversion (cont'd)

- Consequences for U.S. Executives: (cont'd)
  - § 4985 would apply (cont'd).
    - The excise tax is equal to the applicable tax rate multiplied by the value of the "specified stock compensation." It is not a tax on gain.
    - The payment of the excise tax has no effect on the individual's basis in the stock-based compensation and has no effect on the subsequent income tax treatment of the compensation. *See* H.R. Conf. Rep. 108-755 (2004).
    - § 4985 tax applies only if gain on any stock in the expatriated corporation is recognized by any shareholder by reason of the inversion (i.e., if there is shareholder gain under § 367(a)).
    - § 4985 does not apply to any stock option that is exercised on the expatriation date or during the six month period before such date and to the stock acquired in such exercise if income is recognized on or before the expatriation date with respect to the stock acquired pursuant to such exercise.
    - § 4985 does not apply to any other "specified stock compensation" that is exercised, sold, exchanged, distributed, cashed out or otherwise paid during such period in a transaction in which income, gain or loss is recognized in full.
  - § 457A would apply.
    - § 457A, discussed above, practically limits the ability of certain foreign corporations to provide deferred compensation (such as excess 401(k) plans and SERPs) to employees subject to U.S. tax.

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80% or greater inversion

- Consequences to U.S. Parent:
  - § 7874 would apply.
  - Under § 7874, Foreign Parent will be treated as a U.S. corporation (in perpetuity) unless the substantial business activities test is met.
- Consequences to U.S. Parent Shareholders:
  - Because U.S. Parent shareholders receive more than 50% of the shares by vote or value of the Foreign Parent, the Treas. Reg. § 1.367(a)-3(c) requirements are not met.
  - However, if § 7874 applies and Foreign Parent is treated as a U.S. corporation, § 367 will not apply to the transfer of property to Foreign Parent.
- Consequences to U.S. Executives:
  - If § 7874 applies and Foreign Parent is treated as a U.S. corporation, it appears that § 4985 will not apply (even if gain is recognized by shareholders); otherwise, § 4985 will apply.
    - § 4985, discussed above, generally imposes an excise tax on the stock-based compensation of an executive within six months before or after the expatriation date.
  - If § 7874 applies and Foreign Parent is treated as a U.S. corporation, § 457A will not apply; otherwise, § 457A will apply.
    - § 457A, discussed above, practically limits the ability of certain foreign corporations to provide deferred compensation (such as excess 401(k) plans and SERPs) to employees subject to U.S. tax.

Inversions: Substantial Business Activities

- A foreign corporation will not be treated as a surrogate foreign corporation or a domestic corporation, even if there is continuity of shareholder ownership if, after the acquisition the expanded affiliated group has substantial business activities in the relevant foreign country compared to its total business activities (the "substantial business activities" test).
- The term "expanded affiliated group" means an affiliated group as defined in § 1504(a) (without regard to § 1504(b)(3), which excludes foreign corporations), substituting "more than 50%" for "at least 80%" each place it appears.

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Inversions: Substantial Business Activities (cont'd)

- Under the new temporary regulations, the substantial business activities test will apply only if all of the following requirements are satisfied:

  (1) Group employees

  – The number of group employees based in the relevant foreign country must be at least 25% of the total number of group employees on the applicable date. Treas. Reg. § 1.7874-3T(b)(1)(i).

    - A group employee is considered to be based in the relevant foreign country only if he or she spent more time in such country than in any other single country during the testing period. Treas. Reg. § 1.7874-3T(d)(6).

  – The employee compensation incurred with respect to group employees based in the relevant foreign country must be at least 25% of the total employee compensation incurred with respect to all group employees during the testing period. Treas. Reg. § 1.7874-3T(b)(1)(ii).

    - Employee compensation includes wages, salaries, deferred compensation, employee benefits and employer payroll taxes. Treas. Reg. § 1.7874-3T(d)(3).

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Inversions: Substantial Business Activities (cont'd)

- Substantial business activities test (cont'd)

  (2) Group assets

  – The value of group assets located in the relevant foreign country must be at least 25% of the total value of all group assets on the applicable date. Treas. Reg. § 1.7874-3T(b)(2).

    - "Group assets" means tangible personal property or real property used or held for use in the active conduct of a trade or business. Treas. Reg. § 1.7874-3T(d)(5).
    - A group asset is only considered to be located in the relevant foreign country if it was physically present in the county at the close of the acquisition date and for more time than in any other country during the testing period. Treas. Reg. § 1.7874-3T(d)(5).

  (3) Group income

  – The group income derived in the relevant foreign country must be at least 25% of the total group income during the testing period. Treas. Reg. §1.7874-3T(b)(3).

    - "Group income" means gross income of members of the group from transactions occurring in the ordinary course of business with customers that are not related persons (as defined in § 954(d)(3) but substituting "one or more members of the expanded affiliated group" for "controlled foreign corporation"). Treas. Reg. § 1.7874-3T(d)(7).
    - Group income is considered derived in the relevant foreign country only if it is derived from a transaction with a customer located in such country. Treas. Reg. § 1.7874-3T(d)(7).

Inversions: Substantial Business Activities (cont'd)

- The "applicable date" (for testing the number of employees and assets) is either of the following dates (applied consistently):
  - The acquisition date, or
  - The last day of the month immediately preceding the month in which the inversion occurs. Treas. Reg. § 1.7874-3T(d)(2).
- The "testing period" (for testing employee compensation and income and for determining the location of employees and assets) is the one-year period ending on the applicable date. Treas. Reg. § 1.7874-3T(d)(11).

Inversions: Substantial Business Activities (cont'd)

- The following items <u>are not</u> taken into account in the numerator (i.e., the relevant foreign country calculation) but <u>are</u> taken into account in the denominator (*i.e.*, the group calculation):
  - Any group assets, employees or income attributable to business activities that are associated with properties or liabilities that were transferred as part of a plan a principal purpose of which is to avoid the purposes of § 7874;
  - Any group assets or employees located in, or group income derived in, the relevant foreign country as part of a plan with a principal purpose of avoiding the purposes of § 7874; and
  - Any group assets or employees located in, or group income derived in, the relevant foreign country if such group assets/employees/income-producing activity are subsequently transferred to another country in connection with a plan that existed at the time of the inversion. Treas. Reg. § 1.7874-3T(c)(1)-(3).

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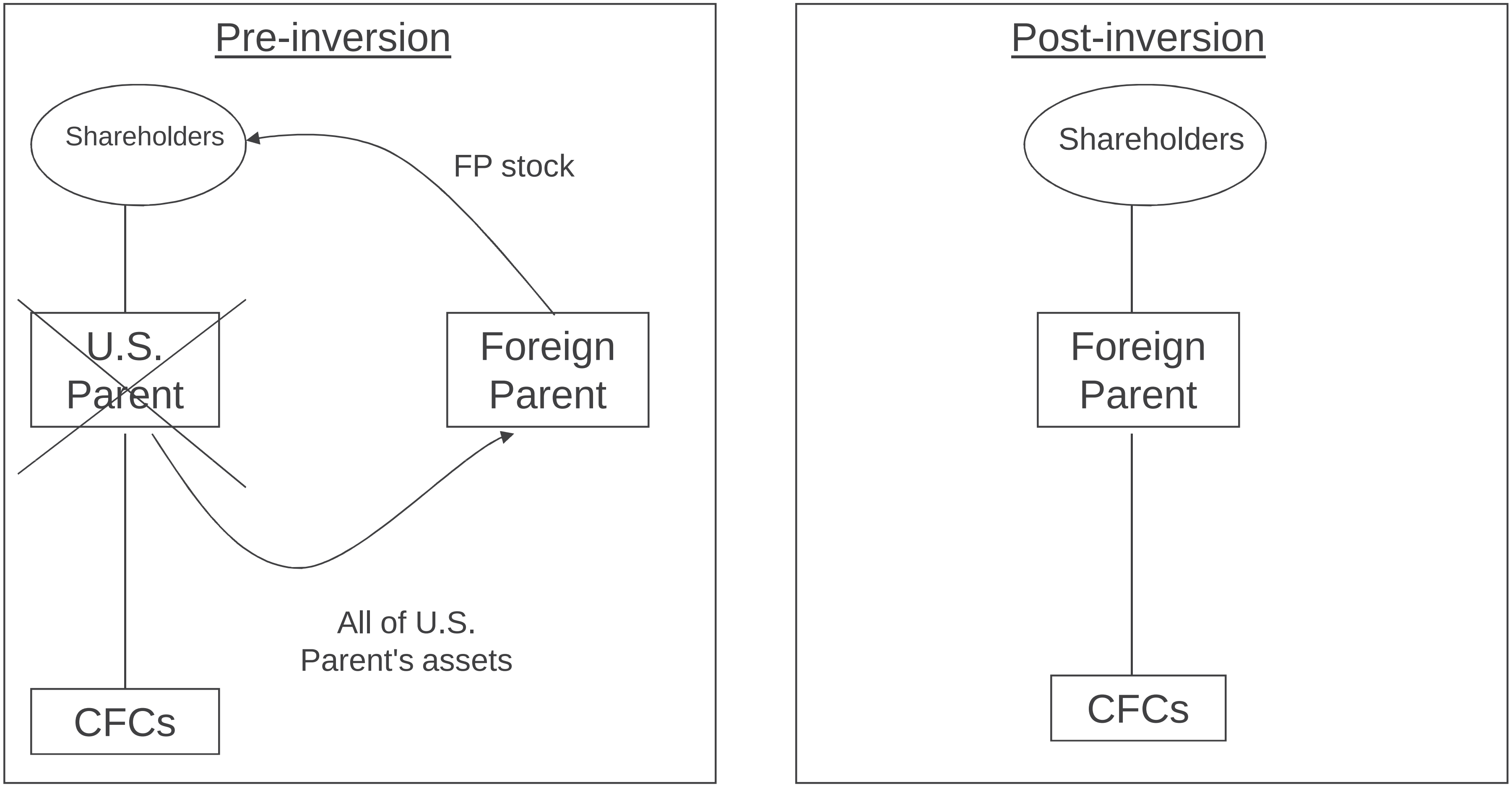
Asset Transaction (cont'd)



- U.S. Parent continues (under state corporate law conversion and continuance procedures) or reincorporates into a tax haven jurisdiction in a § 368(a)(1)(F) reorganization.
- Foreign Parent holds the corporate group previously held by U.S. Parent, and U.S. Parent's shareholders now hold Foreign Parent stock.

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Asset Transaction (cont'd)

- Deemed steps: The following steps are deemed to occur:
  - U.S. Parent transfers assets to Foreign Parent under § 361(a) in exchange for Foreign Parent stock and Foreign Parent's assumption of U.S. Parent's liabilities;
  - U.S. Parent distributes Foreign Parent stock to its shareholders; and
  - U.S. Parent's shareholders exchange their U.S. Parent stock for Foreign Parent stock pursuant to § 354(a).
    - Treas. Reg. § 1.367(a)-1T(f)(1)-(3).

Asset Transaction (cont'd)

- Consequences to U.S. Parent's Shareholders:
  - U.S. shareholders recognize no gain or loss, because the transaction constitutes an F reorganization and does not involve any transfer of assets or stock by the U.S. shareholders to Foreign Parent under § 367(a)(5).
    - Treas. Reg. § 1.367(a)-3(a) (third sentence) and -3(d)(3), ex. 12.
- Consequences to U.S. Parent:
  - U.S. Parent is taxed upon the transfer of assets to Foreign Parent. § 367(a)(5).
  - Applicability of § 7874 will depend on how much stock of Foreign Parent U.S. Parent's former shareholders hold after the transaction.

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Drop Down Transaction

- U.S. Parent transfers its assets to Foreign Parent, which then immediately transfers a portion of those assets to a newly formed U.S. subsidiary of Foreign Parent.
- Analyzed as both an Asset Transaction and a Stock Transaction:
  - Stock Transaction to the extent the assets transferred to Foreign Parent are subsequently transferred to the new U.S. subsidiary.
    - Shareholders of U.S. Parent required to recognize gain (but not loss).
    - § 7874 applies to U.S. Parent depending on how much stock of Foreign Parent are held by former shareholders of U.S. Parent.
  - Asset Transaction to the extent the assets transferred to Foreign Parent are retained by it.
    - Shareholders of U.S. Parent not required to recognize gain.
    - U.S. Parent required to recognize gain (but not loss).
    - § 7874 applies to U.S. Parent depending on how much stock of Foreign Parent are held by former shareholders of U.S. Parent.

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Inversion Examples: Common Themes Employed in Inversions Under the Facts and Circumstances Test **(Pre-Temporary Regulations)**

- Whether there is a merging partner.
- Relocation of senior executives to the foreign country.
- Relocation of corporate presence (i.e., principal executive offices, board meetings, etc.) to the foreign country.
- Relocation to a country where there were historical management and business activities prior to the inversion.
- Continued to conduct business activities in the foreign country after the inversion.

Inversions & Interest Classification: Recent Development in Debt-versus-Equity

- Taxpayers considering inversions or other transactions that contemplate the use of debt or equity should be aware of recent developments in this area
- The IRS has recently issued IDRs to taxpayers with debt-versus-equity issues seeking a broad range of documents
- Several recent court cases have considered whether interests issued as part of either: (1) corporate reorganizations; or (2) pre-packaged investments should be treated as debt versus equity
  - *NA General P'ship v. Commissioner*, T.C. Memo. 2012-172, (certain advances made by a U.S. subsidiary to its foreign parent were debt for tax purposes)
  - *PepsiCo, Inc. v. Commissioner*, T.C. Memo. 2012-269, (Pepsi's interest in certain "Advance Agreements" issued by a foreign subsidiary were more like equity than debt, and PepsiCo was entitled to dividends received deductions)
  - *Hewlett-Packard Co. and Consol. Subs. v. Commissioner*, T.C. Memo. 2012-135, (disallowed foreign tax credits claimed by HP on grounds that HP's interest in a foreign entity was more like debt than equity)
- Each of the above cases undertakes a careful, searching analysis of the multi-factor tests applied to determine whether an interest is debt or equity

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Debt-Versus-Equity: IRS IDR Excerpts

1. Please provide copies of any and all tax opinions related to the US Taxpayer's tax treatment of the related foreign party financing arrangements.

2. Please provide copies of any and all tax opinions related to the foreign related parties' tax treatment of the financing arrangements.

3. Has the Taxpayer or the foreign parent received correspondence from Standards & Poors in any of the years under examination or subsequent to the exam? If so, please provide a copy of the letter(s) from Standards & Poors and any and all attachments and exhibits.

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4. During the years under examination, did the Taxpayer (or an affiliate, either domestic or foreign), solicit and/or obtain a letter or report from a third party (e.g., investment bank, etc.) that would support the determination that the US Taxpayer has the financial capacity to support the related foreign party loans from the foreign affiliate and that the terms and conditions of the related foreign party loans are arm's length (i.e., at fair market value). If yes, please provide a copy of such letter or report plus any and all exhibits and attachments.

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12. In respect to the Taxpayer's credit facility/facilities with bank lenders, please identify and provide copies of information supplied to the banks, including but not limited to, cash flow and other income projections, budgets, etc. to the extent that such information was used by the banks in determining the terms and amount of the credit facility or facilities.

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Moving Executives/Management Activities To the Foreign Parent's Jurisdiction

- It may be necessary to move executives/management activities to the Foreign Parent's jurisdiction:
  - To comply with local law requirements.
  - To be eligible for treaty benefits.
  - If attempting to satisfy the "substantial business activities" test, to satisfy the group employee requirements (25% of group employees and 25% of group compensation must be in the foreign parent's jurisdiction).

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Moving Executives/Management Activities To the Foreign Parent's Jurisdiction (cont'd)

- Treaty requirements:
  - Is there are treaty? If so, what does it require?
  - For example, the Limitation on Benefits ("LOB") provisions in the U.S.-Ireland treaty generally require that one of the following is satisfied:
    - An ownership test and a base erosion test is satisfied;
      - Art. 23(2)(c): Qualified residents or U.S. persons beneficially own at least 50% of the company and a base erosion test is satisfied;
      - Art. 23(5): Imposes a modified ownership/base erosion test where the company is owned by 7 or fewer qualified persons resident in the E.U. or a party to NAFTA.
    - The company is publicly traded or a subsidiary of a publicly traded company (Art. 23(2)(e)); or
    - The company satisfies an active trade or business test (a facts and circumstances test) (Art. 23(3)).
  - Accordingly, if the Foreign Parent is resident in Ireland and relies on the active trade or business test, it may be beneficial to relocate executives and management activities to Ireland.

Consequences of Moving Executives/ Operations To the Foreign Parent

- If executives of the U.S. company also become executives of the Foreign Parent, there may be a risk that the activities of these executives in the U.S. could give rise to a U.S. trade or business or, if there is a treaty, a Permanent Establishment ("PE") in the U.S. with respect to the Foreign Parent.
  - Having a U.S. trade or business/PE should not affect whether other non-U.S. subsidiaries of the Foreign Parent have a U.S. trade or business/PE.
    - *See*, *e.g.*, Art. 5(7) of the U.S.-Ireland Treaty: "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

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U.S. Trade or Business

- The Code and regulations provide no specific definition of a U.S. trade or business.
- Court cases have generally held that a foreign person will generally be found to be engaged in a U.S. trade or business where such person conducts profit-oriented activities in the U.S., whether carried on directly by the foreign person directly or through an agent, if such activities are regular, substantial and continuous.
- The threshold for being considered to be engaged in a U.S. trade or business is typically a very low threshold.
- Note that the mere purchase of services from an independent service provider (that provides such services within the U.S.) should not constitute a U.S. trade or business for the foreign principal.

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Permanent Establishment

- A permanent establishment ("PE") is generally defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on.
  - A PE includes a place of management, an office, factory, a workshop, a mine or a construction site.
- The word "fixed" generally requires that a PE must be established at a distinct place with a certain degree of permanence.
- A PE does not include a facility used solely for:
  - Purchasing, storing, displaying or delivering goods;
  - Maintenance of a stock of goods solely for processing by another person;
  - Collecting information; or
  - Carrying on any other activity of a prepatory or auxiliary character.
- A PE may also arise by imputation from the activities conducted by an agent, whether related or unrelated to an enterprise.
  - An independent agent's activities will not give rise to a PE of the foreign taxpayer in the U.S. if the agent acts for the taxpayer in the ordinary course of the agent's business.
  - However, a foreign taxpayer with a dependent agent in the U.S. will be deemed to have a PE in the country if the agent has and habitually exercises authority to make contracts for the principal and the agent's activities go beyond purchasing and other preparatory or auxiliary activities.

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U.S. "Virtual Headquarters"

- Assume Foreign Parent (FP) has a U.S. subsidiary (U.S. Sub).
- FP frequently conducts certain activities in the U.S., both from the offices of U.S. Sub and elsewhere (e.g., home office of a resident executive).
- Certain "global" executives of the FP group are permanently based in the U.S.
- FP and U.S. Sub also have some "joint" officers and directors.
- The "global" executives and joint officers/directors perform activities for both FP and U.S. Sub.
- Activities conducted by the global executives and/or joint officers in the U.S. may include:
  - Visiting major U.S. customers;
  - Identifying potential acquisition targets;
  - Global (for the entire group) strategic planning;
  - Stewardship/supervisory activities;
  - Coordinating product development, marketing efforts, cost-savings, financings;
  - Signing contracts in the U.S.; and/or
  - Holding certain board meetings in the U.S.

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U.S. "Virtual Headquarters" (cont'd)

- Is FP engaged in a U.S. trade or business?
- A foreign person is engaged in a U.S. trade or business if the person is engaged in regular, substantial and continuous business activity. *See, e.g.*:
  - *Spermacet Whaling*, 281 F.2d 646 (6th Cir. 1960) (whale boat management company not engaged in U.S. business where U.S. activities were limited to receiving correspondence, maintaining a bank account and holding board of directors' meetings).
  - *Abegg,* 50 T.C. 145 (1968), *aff'd*, 429 F.2d 1209 (2d Cir. 1970) (foreign corporation that held directors' meetings in the U.S. and had a U.S. office not engaged in U.S. trade or business) .
  - Treas. Reg. § 1.864-3(b), ex. 2 (foreign corporation owning domestic subsidiaries not engaged in a U.S. trade or business although CEO spends substantial amount of time at U.S. office supervising the foreign corporation's investment).

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U.S. "Virtual Headquarters“ (cont'd)

- If FP is engaged in a U.S. trade or business, does FP have income effectively connected with its U.S. trade or business (ECI)?
  - If FP sells products, title to which passes in the U.S., then its income therefrom is deemed ECI. even if it has no relationship to the activities giving rise to the U.S. trade or business (*e.g.*, the supervisory activities). § 864(c)(3) (residual force of attraction rule).
  - Therefore, better to have title pass outside the U.S.
- If title passes outside the U.S., then income can still be ECI if sales are attributable to a U.S. office or other fixed place of business (unless sold for use outside the U.S. and a foreign office of the taxpayer materially participates in the sale).
  - Is the U.S. office of U.S. Sub attributed to FP? § 864(c)(5)(A); Treas. Reg. § 1.864-7.
    - See Treas. Reg. §§ 1.864-7(c) (management activity) and 1.864-7(g), exs. 1 and 4.
  - Is the U.S. office a "material factor" in the sale? § 864(c)(5)(B); Treas. Reg. § 1.864-6.
    - Meetings in the U.S. of the board of directors of FP do not themselves constitute a material factor. Treas. Reg. § 1.864-6(b)(1).

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U.S. "Virtual Headquarters“ (cont'd)

- Other U.S. source income (FDAP and capital gains) can result in ECI if such income arises from assets used in the U.S. business (never stock) or the business activities of the U.S. business. § 864(c)(2).
  - Service business is deemed to result in ECI under the business activities test. Treas. Reg. § 1.864-4(c)(3)(i) (service fees derived in the active conduct of a servicing business).
- Only limited categories of foreign source income can be ECI. § 864(c)(4).
  - Does FP have a U.S. PE? FP's business is at least partly carried on in the U.S.
  - Is the U.S. office of U.S. Sub "at the disposal of" FP? Does FP regularly carry on its business there?
    - OECD Commentary ¶¶ 4.3 and 41: Employee of a company allowed, for a long time, to use an office in the HQ of another company (e.g., a newly acquired subsidiary) in order to ensure that the latter complies with its obligations under contracts concluded with the former.
    - *See also* proposed changes to ¶ 4.2 in October 2011 OECD discussion draft.

U.S. "Virtual Headquarters" (cont'd)

- Contrast with a situation where the subsidiary performs services (e.g., management services) for the foreign parent as part of the subsidiary's own business:
  - "[T]he fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases… services supplied by another company in a different country would not have a [PE] because of that, even though it may benefit from… the supplying of these services." OECD Commentary ¶ 42.
  - But the above limitation appears to apply only where the premises are not those of the foreign enterprise and only the personnel of the subsidiary carry on the activities through such premises.

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U.S. "Virtual Headquarters“ (cont’d)

- Management activities sometimes can lead to a PE:
  - A FP that manages all or part of an enterprise cannot be regarded as doing preparatory or auxiliary activities.
  - A "management office" with supervisory and coordinating functions for all departments of an enterprise located within a region will normally be deemed to result in a PE.
    - OECD Commentary ¶ 24.
  - Not clear that a board of directors' meeting alone is sufficient to constitute a PE. However, management activities (e.g., officers located in the same place as board of directors' meetings) can clearly constitute a PE.
    - OECD Commentary to Art. 7, at ¶ 38 (pre July 22, 2012).

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U.S. "Virtual Headquarters“ (cont’d)

- If a PE exists, what business profits are attributable to the PE?
  - A lot less clear!
  - In an extreme case, a portion of the profits of the world wide enterprise might be viewed as appropriate.
    - OECD Commentary to Article 7, ¶ 21.
  - OECD indicates that, generally, such allocations would not be appropriate, even though it would be potentially theoretically appropriate.
    - OECD Commentary to Article 7, ¶¶ 21-23.
- If there is ECI but no profits attributable to a PE, then FP would be subject to the § 6114 reporting requirements in respect of treaty-based return position disclosures.

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Steps To Prevent an Unintentional U.S. Trade or Business or PE

- Executives (or other employees) of Foreign Parent should limit activities conducted for the benefit of the global group (or Foreign Parent specifically) while in the U.S.
- To the extent possible, Foreign Parent should hold board meetings, sign documents, etc. in country of residence.

Document Retention Obligations: Foreign Affiliates

- Sections 6038 and 6038A impose information reporting and maintenance obligations on taxpayers that control, or are controlled by, certain foreign entities

- The United States has also entered into a series of treaties and tax information exchange agreements ("TIEAs") that provide the IRS with additional sources of information

- TIEAs have different standards
  - Foreseeably relevant (OECD Model TIEA)
  - May be relevant (U.S.-Panama, U.S.-Brazil, U.S. Model TIEA)
  - As is necessary, must focus on tax fraud, not just evasion (see U.S.-Swiss double tax treaty, but see new proposed Protocol)

Tax Information Exchange Agreements

- Types of requests:
  - Specific exchanges of information
  - Spontaneous exchanges
  - Automatic exchanges of information
- TIEAs allow for information flows different from those typically present in corporate organizations
  - Typically corporations are based on hierarchical information flows: information flows upward or downward, but it may not flow across the organization
  - Thus, a lower-level subsidiary in Ireland or the Bahamas may not be transferring information to a lower-level subsidiary in the United States or other country
- TIEAs allow for cross-border flows of information at lower levels in the corporate hierarchy; thus, a tax authority at the subsidiary level can transfer information to the tax authority in a different country at a sister-level

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Questions?

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IRS Circular 230 Notice

Any advice expressed in this document as to tax matters was neither written nor intended to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under U.S. tax law. If any person uses or refers to any such tax advice in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer Brown LLP) of that transaction or matter, and (ii) such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

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SECTION OF TAXATION
State Bar of Texas

April 9, 2013

__VIA U.S. MAIL & FEDERAL eRULEMAKING PORTAL__
__HTTP://WWW.REGULATIONS.GOV__

CC:PA:LPD:PR (REG-138006-12)
Internal Revenue Service
Room 5203
POB 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Regulations Under Section 4980H of the Internal Revenue Code of 1986, as amended, Relating to Shared Responsibility for Employers Regarding Health Coverage

Dear Ladies and Gentlemen:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Internal Revenue Service and the Department of the Treasury for comments concerning the proposed regulations relating to shared responsibility for employers regarding health coverage.

THE COMMENTS AND ACCOMPANYING REQUEST FOR ADDITIONAL GUIDANCE ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THIS REQUEST AND THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE REQUEST FOR THE ISSUANCE OF ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT

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SUBMISSION OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR THIS REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS AND THIS REQUEST AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We appreciate the Internal Revenue Service and the Department of thc Treasury permitting us to submit these comments and request for additional guidance and being extended the opportunity to participate in this process.

Sincerely,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
State Bar of Texas

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COMMENTS AND REQUEST FOR ADDITIONAL GUIDANCE WITH RESPECT TO PROPOSED REGULATIONS RELATING TO SHARED RESPONSIBILITY FOR EMPLOYERS REGARDING HEALTH COVERAGE

These comments and request for additional guidance with respect to the proposed rules relating to shared responsibility for employers regarding health coverage under section 4980H of the Internal Revenue Code of 1986, as amended ("Code"), that were issued by the Internal Revenue Service (the "Service") and the Department of the Treasury ("Treasury") on December 28, 2012, as published in 78 Federal Register 218 (January 2, 2013) ("Proposed Treasury Regulations"), are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafter of these comments was Henry Talavera, Vice-Chair of the Compensation and Employee Benefits Committee of the Section of Taxation of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Section of Taxation of the State Bar of Texas has approved these comments. Stephanie Schroepfer is the Chair of COGS. Substantive comments were provided by Courtney Vomund, Kirsten Garcia and Susan A. Wetzel. Mark A. Bodron reviewed these comments on behalf of COGS.

Although many of the people who participated in preparing, reviewing, and approving these comments have clients who will be affected by the federal tax law principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the subject matter of these comments.

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Date: April 9, 2013

I. EXECUTIVE SUMMARY

The following submission contains comments and request for additional guidance with respect to the future application of the Proposed Treasury Regulations relating to shared responsibility for employers regarding health coverage under section 4980H of the Code ("4980H")[1], which was added to the Code by section 1513 of the Patient Protection and Affordable Care Act.[2]

The following is a summary of our comments and requests:

A. We respectfully suggest that it is not administratively practicable to determine the full-time status of a Commissioned Employee by any method that requires the actual tracking of hours or equivalencies that are more suitable for salaried employees, because Commissioned Employees typically set their own schedule and work hours. In response to this issue, we respectfully request that the Service and Treasury establish three safe harbors options, any one of which an employer may elect to use, to determine whether an employee who is compensated on a commission or similar basis (and who is not compensated on an hourly rate or a fixed salary basis) ("Commissioned Employee") should be presumed to be a "full-time employee" for purposes of 4980H, as follows:

(i) The Commissioned Employee will be deemed to be a full-time employee if the commissions and other compensation determined consistent with the Proposed Treasury Regulations ("Commissions") earned by the employee equal or exceed the Federal poverty line ("FPL").

(ii) The Commissioned Employee will be deemed to be a full-time employee if the employee earns Commissions based upon a converted dollar per hour which indicates that he worked 30 hours per week on average, with the dollars per hour for the Commissioned Employee determined as the quotient of "x" divided by "y," where:

x. The numerator equals the Commissioned Employee's total annual Commissions over the applicable period; and

y. The denominator equals

a. the Federal minimum wage (currently $7.25/per hour),

b. the lowest hourly rate of compensation paid to such employee or any other Commissioned Employee during the applicable period with respect to which the Compensation is determined, or

[1] Except as otherwise specified, all section references herein are references to the applicable sections of the Code.
[2] The Patient Protection and Affordable Care Act was enacted March 23, 2010, Public Law 111-148, and amended by section 1003 of the Health Care and Education Reconciliation Act of 2010, enacted March 30, 2010, Public Law 111-152, and further amended by the Department of Defense and Full-Year Continuing Appropriations Act, 2011, Public Law 112-10 (collectively, the "Affordable Care Act").

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c. any other wage per hour paid to the Commissioned Employee at any time during such year or, if none, such wages as are paid to other similarly situated Commissioned Employees reasonably determined by the employer based on an employer's workforce over the applicable period during which the Commissioned Employee worked for the employer and the Commissions are determined.

The resulting dollar per hour quotient would then be used to calculate an average number of hours per week for the Commissioned Employee and if the results equal 30 or more hours per week over the applicable period the employee will be treated as a full-time employee (the same as any other hourly employee).

(iii) The bottom 2.5% of similarly situated Commissioned Employees will deemed to be part-time employees, with the remaining 97.5% of the similarly situated Commissioned Employers deemed to be full-time employees, based on the Commissions earned by such employees. We believe that the Commissioned Employees in the bottom 2.5% would not reasonably be expected to be treated the same as other Commissioned Employees based upon a statistical analysis. For purposes of any such determination, "similarly situated" Commissioned Employees would include any Commissioned Employee who provides the same types of services to a similar client of the employer as would be reasonably and consistently determined by the employer. This standard would allow employers to determine with reasonable confidence the lowest earning, similarly situated, full-time Commissioned Employee, as all full-time employees would be expected to be within a 95% confidence interval of any average or median. For example, a salesperson who sells a certain piece of medical clothing to stores (*e.g.*, scrubs) should be treated the same as any other similarly situated Commissioned Employee selling such medical clothing.

We believe that by adopting the suggested safe harbors described above, the Service and Treasury can reach an appropriate balancing of the need to comply with the requirements of 4980H and the need for employers to have a workable administrative structure that allows them to comply with those requirements for their Commissioned Employees.

Finally, we respectfully suggest that employees who are paid on a Commission basis be treated the same as any other variable or seasonal employee ("variable employee") and that an employer be permitted to use a 12-month look-back measurement period for Commissioned Employees.

B. Regarding the Form W-2 safe harbor for determining whether an employer's coverage satisfies the 9.5% affordability test for purposes of the assessable payment under section 4980H(b), we respectfully suggest that the Form W-2 safe harbor be determined at the beginning of the calendar year based on the Commissioned Employee's Form W-2 wages from the previous year ("Prior Year Wage Safe Harbor"), as opposed to the Form W-2 safe harbor being determined at the end of a calendar year based on that year's Form W-2 wages.

We respectfully recommend that this Prior Year Wage Safe Harbor be available only if the average "compensation" (as otherwise determined under the Proposed Treasury Regulations) for all continuing employees of an employer who were both employed by the employer during the prior year and who remain employed during the current year is not reasonably expected to decrease during the coming year by more than a marginal amount specified by the Service and Treasury (for example, 10%). Further, such average may not in fact decrease by more than such marginal amount, subject to an extreme business hardship or business necessity which could include a bankruptcy, plant shut down or layoffs involving an employer's business comparable to a substantial business hardship described in section 412(c) ("Business Hardship"). Within a reasonable period from the date a Business Hardship occurs (not to exceed the beginning of the next plan year), the employer would need to use one of the other existing safe harbors for determining affordability at least one year following the year in which the Business Hardship occurs.

C. We respectfully suggest that the definition of "seasonal employee" provide that (i) an employee will be treated as a seasonal employee if the employee is not reasonably expected to work more than six months during the applicable period; (ii) an employee will not be treated as a seasonal employee if the employee is reasonably expected to work more than nine months; and (iii) an employee who is reasonably expected to work more than six months but less than ten months will be treated as a seasonal employee if such treatment is supported by the facts and circumstances.

D. We respectfully request that the Service and Treasury expressly permit or clarify that a measurement period for variable employees with respect to plan years beginning on or after January 1, 2014, can begin in 2012. For example, a measurement period should be able to begin on October 15, 2012, and end on October 14, 2013, with a corresponding administrative period which ends on January 1, 2014.

Further, we suggest that employers should be expressly permitted to retroactively establish tracking systems to determine whether an employee has on average worked 30 hours per week during a 12-month measurement period. Finally, we would ask the Service and Treasury expressly specify when amendments may be necessary or otherwise due with respect to a medical plan to establish measurement or stability periods.

E. We respectfully request that the Service and Treasury expressly confirm that an employer may provide mandatory coverage if (i) the employer is exempt from the automatic enrollment requirements set forth in Section 18A of the Fair Labor

Standards Act; (ii) such mandatory coverage is part of the terms and conditions of employment and is "affordable" and provides "minimum value," as such terms are defined for purposes of 4980H; and (iii) the employer complies with any applicable state laws which require an employee's consent to withhold any amounts from an employee's paycheck with respect to such mandatory coverage.

II. BACKGROUND

A. Full-Time Status of Commissioned Employees

For purposes of 4980H, a full-time employee is an employee who was employed on average at least 30 hours per week (130 hours per month).[3] The Service and Treasury, in consultation with the Department of Labor ("DOL"), is authorized to prescribe guidance for employees who are not compensated on an hourly basis, such as Commissioned Employees.[4] The term "hours of service" includes not only hours when work is performed but also hours for which an employee is paid or entitled to payment even when no work is performed.[5] The Proposed Treasury Regulations provide general guidance for calculating hours of service and determining how to identify an employee as a full-time employee.

In the Proposed Treasury Regulations, the Service and Treasury recognize the concerns of requiring a full-time employee to be determined based on the numbers of hours worked. The Service and Treasury noted that commentators requested special rules for employees whose compensation is not based primarily on hours.[6] The Proposed Treasury Regulations provide that until further guidance is issued, employers of Commissioned Employees must use a "reasonable method for crediting hours of service that is consistent with the purposes of 4980H."[7] The Proposed Treasury Regulations specify that a method of crediting hours would not be reasonable if it took into account only some of an employee's hours of service to avoid classifying an employee as working full-time. For example, it would not be reasonable to fail to take into account travel time for a travelling salesperson who is a Commissioned Employee.

In Section III.A. below we provide our suggestions concerning appropriate standards for determining whether a Commissioned Employee constitutes a full-time employee.

B. Form W-2 Safe Harbor Calculation Period

Liability under 4980H may arise if an employer provides coverage that is unaffordable within the meaning of section 36B(c)(2)(C)(i). Coverage for an employee under an employer-sponsored plan is affordable if an employee's required contribution (within the meaning of section 5000A(e)(1)(B)) for self-only coverage does not exceed 9.5% of the employee's household income for the taxable year.[8] The Form W-2 safe harbor was proposed as an affordability safe harbor in Notice 2011-73. Comments were favorable on the proposed Form

[3] Section 4980H(c)(4); Proposed Treasury Regulation section 54.4980H-3(b).
[4] Section 4980H(c)(4)(B).
[5] Proposed Treasury Regulation section 54.4980H-3(b).
[6] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 225.
[7] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 225.
[8] Section 36B(c)(2)(C)(i), Section 36B(d)(2).

W-2 safe harbor and, accordingly, the Proposed Treasury Regulations include the Form W-2 safe harbor, as well as two other safe harbor tests for affordability.[9]

The employee's eligibility for a premium tax credit under section 36B is based on the cost of employer-sponsored coverage relative to an employee's household income. Accordingly, the effect of the safe harbor may be to treat an employer's offer of coverage to an employee as affordable, based on such employee's Form W-2 wages for purposes of determining whether the employer is subject to an assessable payment under section 4980H(b), while the same offer of coverage could be treated as unaffordable (based on household income) for purposes of determining whether the employee is eligible for a premium tax credit under section 36B.[10]

The Form W-2 safe harbor set forth in the Proposed Treasury Regulations provides that an employer may determine affordability for purposes of section 4980H(b) liability by referring to the total amount of wages reported in Box 1 of Form W-2. For the Form W-2 safe harbor to apply, the employer must offer its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, and the required employee contribution toward the self-only premium for the employer's lowest cost coverage that provides minimum value may not exceed 9.5% of the employee's Form W-2 wages.[11] This safe harbor is applied after the end of the calendar year and on an employee-by-employee basis. Accordingly, at the end of the year, the employer must review an employee's actual wages and determine whether the employee contribution amount that was set at the beginning of the year is 9.5% or less of the employee's wages. The Proposed Treasury Regulations acknowledge that an employer could use the safe harbor prospectively to set the employee contribution level, but if the contribution level ultimately exceeds 9.5% of the employee's Form W-2 wages, the employer will not be permitted to apply this safe harbor.[12]

In Section III.B. below we provide an additional alternative safe harbor for consideration by the Service and Treasury.

C. Seasonal Employee Definition

The Proposed Treasury Regulations define "seasonal worker" but have reserved a section of the regulations for the definition of "seasonal employee." Section 4980H(c)(2)(B)(ii) defines a seasonal worker as one who performs labor or services on a seasonal basis, as defined by the Secretary of Labor, including workers who are covered by 29 C.F.R. section 500.20(s)(1) and retail workers who are employed exclusively during holiday seasons. The DOL regulations provide, in relevant part, that:

> "(l)abor is performed on a seasonal basis where, ordinarily, the employment pertains to or is of the kind exclusively performed at certain seasons or periods of the year and which, from its nature, may not be continuous or carried on throughout the year. A worker who moves from one seasonal activity to another, while employed in agriculture or performing agricultural labor, is employed on a

[9] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 233.
[10] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 233.
[11] Proposed Treasury Regulation section 54.4980H-5(e)(2)(ii).
[12] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 234.

seasonal basis even through he may continue to be employed during a major portion of the year."[13]

The Service and Treasury have determined that the term seasonal worker is not limited to agricultural or retail workers.[14]

Until a definition of seasonal employee is established, employers are permitted to use a reasonable, good faith interpretation of the term seasonable employee for purposes of 4980H.[15] The preamble to the Proposed Treasury Regulations states that the final Treasury Regulations may add to the definition of seasonal employee a specific time limit in the form of a defined period.

In Section III.C. below we provide what we believe is a reasonable limit of the period after which an employee should not be permitted to be treated as a seasonal employee.

D. <u>Measurement Periods for Stability Periods Starting in 2014</u>

The preamble of the Proposed Treasury Regulations provides that a six-month look-back may be applicable for measurement periods which begin in 2013, as follows:

> Section 4980H is effective for months beginning after December 31, 2013. Employers that intend to utilize the look-back measurement method for determining full-time status for 2014 will need to begin their measurement periods in 2013 to have corresponding stability periods for 2014. Treasury Department and the IRS recognize, however, that employers intending to adopt a 12-month measurement period, and in turn a 12-month stability period, will face time constraints in doing so. Consequently, solely for purposes of stability periods beginning in 2014, employers may adopt a transition measurement period that is shorter than 12 months but that is no less than 6 months long and that begins no later than July 1, 2013 and ends no earlier than 90 days before the first day of the plan year beginning on or after January 1, 2014 (90 days being the maximum permissible administrative period).[16]

In Section III.D. below we ask the Service and Treasury for additional clarification that a 12-month measurement period for variable employees may commence in 2012.[17]

Further, we believe that employers should also expressly be permitted to retroactively establish tracking systems to determine whether an employee has on average worked 30 hours

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[13] 29 C.F.R. section 500.20(s)(1) (emphasis added).
[14] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 222.
[15] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 227.
[16] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 237.
[17] Notice 2012-58 ("This reliance covers a measurement period that begins in 2013 or 2014 and the associated stability period (which may extend into 2014, 2015 or 2016). For example, the use of a 12-month measurement period in accordance with this notice beginning on July 1, 2013 and ending on June 30, 2014 might be used to classify employees for a stability period that runs from July 1, 2014 through June 30, 2015.").

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per week during a 12-month measurement period. There has been some confusion over whether tracking systems can only be prospectively established or determined.[18]

E. Mandatory Coverage

In its rationale behind the "offer of coverage" requirement, the preamble of the Proposed Regulations provides, in part, that:

> The employee must also have an effective opportunity to decline an offer of coverage that is not minimum value coverage or that is not affordable. Thus, an employer may not render an employee ineligible for a premium tax credit by providing an employee with mandatory coverage (that is, coverage which the employee is not offered an effective opportunity to decline) that does not meet minimum value.[19]

As drafted, this language suggests that an employer could require mandatory coverage as long as such coverage is both "affordable" and provides "minimum value." However, the offer of coverage requirement in the Proposed Treasury Regulations does not appear to incorporate that rationale.[20] Instead it appears to directly contradict the language in the preamble by requiring that all employees be given the opportunity to decline coverage, even if such coverage is affordable and provides minimum value.

In Section III.E. below we request that the Service and Treasury expressly confirm the availability of mandatory coverage that meets certain requirements.

III. REQUEST FOR ADDITIONAL GUIDANCE

A. We Respectfully Request that the Service and Treasury Consider Three Safe Harbor Options for Determining the Full-Time Status of Employees Compensated on a Commission Basis

We respectfully suggest that it is not administratively practicable to determine the full-time status of a Commissioned Employee by any method that requires the actual tracking of hours or equivalencies more applicable to salaried employees, because Commissioned Employees typically set their own schedule and work hours. In light of this issue and in accordance with the invitation for further comment on how best to determine the full-time status of employees who are compensated on a commission basis, rather than on the basis of hours worked, we respectfully suggest three safe harbor options that employers could use for evaluating such employees. Our suggested methods avoid basing the determination of full-time status on any attempt to track the actual hours worked by these employees. Our rationale is two-fold. First, the hours worked by Commissioned Employees are often difficult, if not impossible, to verify and track accurately, particularly if the employees do not work at the employer's

[18] *See* Florence Olsen, Variable-Hour Worker Count Must Start Soon for Some Employers, Speaker Says, Bloomberg BNA Daily Tax Report (March 8, 2013).
[19] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 232.
[20] Proposed Treasury Regulation sections 54.4980H-4(b) & -5(b).

building or office. Second, hours worked by a Commissioned Employee do not have any direct correlation to the amount of compensation earned by the Commissioned Employee.

The first proposed safe harbor option for evaluating Commissioned Employees is to create a floor under which a Commissioned Employee should not be considered a full-time employee. We respectfully submit that the threshold amount could be tied to the FPL (similar to the FPL safe harbor established by the Proposed Treasury Regulations for purposes of determining the 9.5% premium threshold).[21] For example, if the wages reported on the employee's Form W-2 for the measurement period was at least the FPL, the employee will be considered a full-time employee for the stability period.

We respectfully suggest that the FPL expressly takes into account Commissioned Employees to provide that a Commissioned Employee is not a full-time employee if such employee earned less than the FPL, because an employee who earns less than the FPL should be Medicaid eligible in states which have opted into Medicaid (and we suggest that such employee should not otherwise count against an employer under 4980H, particularly with respect to Commissioned Employees for whom hours are not readily available).

A second proposed safe harbor option for evaluating Commissioned Employees is to calculate a projected number of hours by dividing the employee's total annual compensation by a certain hourly or monthly wage. We respectfully submit that the wage could be the Federal minimum wage, or a reasonable wage based upon the lowest hourly rate of compensation paid to such Commissioned Employee or any other Commissioned Employee. This would be consistent with how non-hourly employees would be determined under the DOL's regulations that are applicable to retirement plans.[22]

We also respectfully ask that the Service and Treasury permit an employer to use any hourly rate paid to the Commissioned Employee for such year (based upon hours worked or salary paid to an employee for a period of hours worked during such year). If no such hourly rate was paid to the Commissioned Employee, we suggest that the employer be permitted to establish any other wage per hour reasonably determined by the employer for similarly situated Commissioned Employees based on an employer's workforce over the applicable period during which the Commissioned Employee worked for the employer as a Commissioned Employee. Of course, an employer would need to be reasonable and set an appropriate wage which is not so unreasonably high that more than 5% of all full-time Commissioned Employees would likely be excluded (we selected 5% because the Service and Treasury permit 5% of all employees to be excluded without being subject to penalties under 4980H).[23] For example, an employer should arguably be permitted to select the average wage of all other employees to determine the appropriate hourly wage for the Commissioned Employees, because the average of the wages for all other employees of the employer would arguably establish an average market wage for all employees of such employer, including, arguably the Commissioned Employees.

A third proposed safe harbor suggests an alternative for Commissioned Employees based upon the lowest 2.5% paid similarly situated Commissioned Employees of an employer. If the

[21] Proposed Treasury Regulation section 54.4980H-5(e)(2)(iv).
[22] 29 C.F.R. section 200b-2(b)(2)(C).
[23] Preamble to the Proposed Treasury Regulations, 78 Federal Register 1 at 232-33.

average of all Commissions for similarly situated Commissioned Employees falls within two standard deviations (or a margin of error) from an average or median amount of Commissions earned by all such similarly situated Commissioned Employees over the applicable period, this should be permissible. The employer would need to have a reasonable basis for treating each group of similarly situated Commissioned Employees as one group for this purpose (e.g., the same type of salesman for the same product line should be treated the same as any other salesman under that product line).

The two standard deviation measurement is commonly known as the "confidence interval." This would allow employers to determine with reasonable confidence the lowest earning full-time Commissioned Employee, as all full-time employees would be expected to be within a 95% confidence interval of any average or median. This would basically mean that the bottom 2.5% of similarly situated Commissioned Employees (half of the 5% outside of the two (2) standard deviations) would be excluded as part-time employees, because those Commissioned Employees would not reasonably be expected with confidence to be treated the same as other Commissioned Employees, as those employees would be outliers from a statistical standpoint. We suggest that it is reasonable to assume that the lowest 2.5% of similarly Commissioned Employees are not working remotely as hard as the other 97.5% of such Commissioned Employees if they underperform in this manner. Typically, such under-performers would lose their job.

The only other reasonable explanation would be that such Commissioned Employees were not working even close to full-time and were working on a part-time basis. While this is not a perfect solution, it allows employers to exclude the lowest paid Commissioned Employees, but on the whole we would assert that it should be statistically and mathematically permissible to treat all similarly situated Commissioned Employees the same by excluding those lowest paid Commissioned Employees.

Because of the variable nature of Commissioned Employees' compensation, we also respectfully suggest that Commissioned Employees be treated the same as any other variable employee and that an employer be permitted to use a 12-month look-back measurement period for those Commissioned Employees.

We believe that the safe harbor options described above provide a workable administrative structure for use by employers to comply with the requirements of 4980H, and avoid the assessable payment under 4980H(b).

B. <u>We Respectfully Request that the Service Reconsider Having the Form W-2 Safe Harbor be Determined at the End of a Calendar Year</u>

We commend the Service and Treasury for creating three affordability safe harbors to determine whether an employer's coverage satisfies the 9.5% affordability test for purposes of the assessable payment under 4980H(b). However, we believe that it will be difficult for an employer to comply with a safe harbor that requires the employer to calculate the employee contribution to the employer-sponsored health plan based on compensation that has not yet been earned during such plan year. Accordingly, we respectfully suggest that the Form W-2 Safe Harbor could be applied by using the wages reported on Form W-2 for the previous calendar year. In order to be considered "affordable," the employer contribution could not exceed 9.5% of the employee's Form W-2 wages for the immediately prior year. We suggest that this is appropriate, because an employer has no direct control over Commissions earned by employees and Commissions are generally earned over random periods.

For example, we suggest that an employer would calculate the employee contribution to its health plan for 2014 by reviewing the Form W-2 wages of employees on the 2013 Form W-2. We suggest that employers will have increased success in providing affordable coverage if they are able to calculate the 9.5% standard based on known compensation. We suggest that the safe harbor would not apply if the employer on average significantly decreased employees' compensation during the subsequent year.

We respectfully submit that a change of 5% could be considered a "significant" change. Further, such average could not in fact decrease by more than that such significant amount, subject to a Business Hardship. Within a reasonable period from the date an employer reasonably establishes a Business Hardship (not to exceed the beginning of the next plan year) the employer would need to use one of the other existing safe harbors for determining affordability for at least one year following the year in which the Business Hardship occurs.

C. <u>We Respectfully Request that the Service Add a Definite Period of Time to the Definition of "Seasonal Employee"</u>

We respectfully suggest that it is appropriate to include a definite time period in the definition of "seasonal employee." The Proposed Treasury Regulations indicate that the Service and Treasury is contemplating adding a time frame to the definition of seasonal employee. We respectfully suggest that adding a time frame to these definitions will create a clear standard that will be useful for employers in applying the rules set forth in the Proposed Treasury Regulations to seasonal employees. We respectfully submit that the current standard in the definition of "seasonal employee" is difficult to apply and may invite abuse of the rules by employers with employees who do not work a full twelve months during a year. An identical standard should also apply with respect to a "seasonal worker" under the Proposed Treasury Regulations.

We respectfully suggest a definition of seasonal employee that provides that during a plan year (or an applicable measurement period lasts one year, as appropriate) (i) an employee will be treated as a seasonal employee if the employee is not reasonably expected to work more than six months; (ii) an employee will not be treated as a seasonal employee if the employee is reasonably expected to work more than nine months; and (iii) an employee who is reasonably expected to work more than six months but less than ten months will be treated as a seasonal employee if such treatment is supported by the facts and circumstances. We respectfully submit that under the suggested approach employees that work more than six months during such year would generally not be considered seasonal employees absent unusual circumstances to be determined by an employer and then only for a period that is less than ten months. We believe that proportional adjustments would be appropriate for measurement periods of less than one year.

D. We Respectfully Request that the Measurement Periods for Stability Periods Starting in 2014 Can Begin in 2012

The language highlighted above indicates that a measurement period for 2014 must begin in 2013 in all circumstances. We respectfully request that the Service and Treasury provide that measurement periods can begin in 2012 (*i.e.*, a measurement period beginning on October 15, 2012, should be permitted to end on October 14, 2013). We suggest that it would be arbitrary to limit measurement periods only for periods beginning in 2012, as it does not appear that measurement periods will be limited for any subsequent years.

Further, employers should also expressly be permitted to retroactively establish tracking systems to determine whether an employee has on average worked 30 hours per week during a 12-month measurement period. There has been some confusion over whether tracking systems can only be prospectively established or determined by employers. Finally, it is not clear when amendments may be due in a medical plan to establish measurement or stability periods. We believe that guidance regarding this issue would be appreciated.

E. We Respectfully Request Confirmation of the Availability of Mandatory Coverage

The discussion in the preamble to the Proposed Treasury Regulations regarding mandatory coverage focuses on situations where an employer may use such coverage to prevent an employee from being eligible for the premium tax credit when such coverage is either unaffordable or fails to provide minimum value. Otherwise, the preamble indicates that the Service and Treasury would not object to an employer having mandatory coverage if such coverage is affordable and provides minimum value.

However, Proposed Treasury Regulation sections 54.4980H-4(b) and 54.4980H-5(b) seem to indicate that mandatory coverage is not available even if such coverage is affordable and provides minimum value.[24] We respectfully request that, consistent with the preamble, the Proposed Treasury Regulations be revised to make clear that mandatory coverage is permitted if (i) the employer is exempt from the automatic enrollment requirements set forth in Section 18A of the Fair Labor Standards Act (*i.e.*, relatively small employers);[25] (ii) such mandatory coverage is part of the terms and conditions of employment and is "affordable" and provides "minimum value," as such terms are defined for purposes of 4980H; and (iii) the employer complies with any applicable state laws which require an employee's consent to withhold any amounts from an employee's paycheck with respect to such mandatory coverage.

One important reason for permitting an employer to make coverage a mandatory condition of employment is that the employer may need to require mandatory coverage in order to satisfy an insurer's minimum participation requirements. With the expansion in eligibility and

[24] *See* Proposed Treasury Regulation section 54.4980H-4(b) ("An applicable large employer member will not be treated as having made an offer of coverage to a full-time employee for a plan year if the employee does not have an effective opportunity to elect to enroll (or decline to enroll) in the coverage no less than once during the plan year.").
[25] As added by section 1511 of the Affordable Care Act.

probability that many of the newly eligible employees will not enroll, an employer may need mandatory coverage in order to obtain insurance coverage. Insurers generally require a minimum percentage of an employer's employees to enroll in coverage. This proposed limited exception would help relatively small employers ensure they have adequate enrollment in their plans in order to meet any insurer's minimum participation requirements.

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SECTION OF TAXATION
State Bar of Texas

April 12, 2013

via email to bryant.lomax@cpa.state.tx.us

Mr. Bryant Lomax
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
P.O. Box 13528, Capitol Station
Austin, Texas 78711-3528

RE: **Comments Concerning Proposed Amendments to Comptroller Rule 3.588**

Dear Mr. Lomax:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed comments pertaining to proposed amendments to Texas Comptroller of Public Accounts Rule 3.588 published in the March 15, 2013 edition of the Texas Register (at 38 TexReg 1840). THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENTAL SUBMISSIONS OF THE STATE BAR OF TEXAS SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE SECTION OF TAXATION MEMBERS WHO PREPARED THEM.

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We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
The State Bar of Texas

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RESPONSE TO REQUEST FOR COMMENTS REGARDING PROPOSED AMENDMENTS TO COMPTROLLER RULE 3.588

These comments with respect to proposed amendments to Comptroller Rule 3.588 are presented on behalf of the Section of Taxation of the State Bar of Texas (the "Section"). The principal drafters of these comments are the Chair and Vice Chairs of the Section's Committee on State and Local Taxation: Ira Lipstet, Charolette Noel, Sam Megally and Matt Hunsaker as well as Section Council member Alyson Outenreath. The Section's Committee on Government Submissions ("CGS") has approved these comments. Stephanie Schroepfer is the Chair of CGS and Dan Micciche reviewed this response to request for comments on behalf of CGS.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: April 12, 2013

I. EXECUTIVE SUMMARY

These comments are in response to the Texas Comptroller of Public Accounts (the "Comptroller") proposed amendments to 34 Tex. Admin. Code § 3.588 relating to cost of goods sold ("COGS") ("Proposed Rule § 3.588")[1] published in the March 15, 2013 edition of the Texas Register (at 38 Tex. Reg. 1840).

II. INTRODUCTION

We recognize and appreciate the challenges facing the Comptroller when balancing limited resources with the tasks of providing useful and reliable taxability guidance and information that promotes voluntary compliance with state tax laws. We also want to express our appreciation to the Comptroller personnel for their efforts to encourage a dialog on the issues addressed in Proposed Rule § 3.588. We recognize and appreciate that the Comptroller has thoughtfully considered suggestions and comments in recent discussions with interested parties and has incorporated many of the comments raised in those discussions. It is our intent to present items for further consideration that may help and support the Comptroller personnel to more efficiently and effectively perform these important tasks.

The focus in these comments is on (i) the modification and/or addition of Rule provisions that dictate what may be included in the computation of the COGS deduction from total revenue when determining taxable margin for Texas franchise tax purposes; and (ii) the Rule provisions relating to amending a COGS election. Following are comments and suggestions addressing those issues.

III. PROPOSED RULE § 3.588 COMMENTS

According to the preamble to the Proposed Rule ("Preamble"), the Comptroller's office has proposed changes to Rule 3.588 pertaining to computation of COGS for franchise tax purposes that include (among other changes): 1) amendment of subsection (b)[2] to add new paragraph (9) which defines the term "service costs"; 2) amendment of subsection (d) to clarify which expenses qualify as direct costs of acquiring or producing goods under Texas Tax Code[3] § 171.1012(c); and (3) modify subsection (c)(3) to allow for changing the initial deduction election to COGS.

We appreciate the Comptroller's efforts to establish Rule provisions to provide guidance and clarification with respect to determining COGS for franchise tax purposes. In keeping with the Comptroller's goals of fair and efficient tax administration, we recommend certain modifications and clarifications to Proposed Rule § 3.588 as described below.

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[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

[2] Inadvertently referenced as (a)(9) in the Preamble.

[3] Hereinafter, all references to "Tax Code" are to the Texas Tax Code.

A. Service Cost Definition in Proposed Rule § 3.558(b)(9)

Proposed Rule subsection (b)(9) defines the term "service costs," borrowing heavily from the Internal Revenue Code regulatory definition in 26 Code of Federal Regulations[4] ("CFR") § 1.263A-1(e)(4)(i). Proposed Rule subsection (f)(1) lists examples of service costs, borrowing heavily from examples listed in 26 CFR § 1.263A-1(e)(4)(iii). {Placing these two references Proposed Rule §§ 3.588(b)(9) and 3.588(f)(1)) in different Rule subsections could cause confusion and be read as competing definitions. We recommend moving the examples listed in (f)(1) to the definition of service cost in (b)(9) and clarifying that the list provides illustrative examples of costs meeting the definition of service costs. Accordingly, "service costs" could be defined consistent with 26 CFR § 1.263A-1(e)(4)(i)(A) and B as "indirect costs, including general and administrative costs, that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function. For purposes of this section, a service department or function includes personnel (including costs of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees); accounting (including accounts payable, disbursements, and payroll functions); data processing; security; legal; general financial planning and financial management; and other similar departments or functions."

B. Deduction in Proposed Rule § 3.558(d)(1) Allowed for Labor Costs Described in 26 CFR 1.263A-1(e) Regardless of Whether Excluded under 26 CFR 1.263A-1(b)

Proposed Rule subsection (d)(1) allows a deduction for labor costs (other than service costs) that "are of the type subject to capitalization or allocation under Treasury Regulation Sections 1.263A-1(e) or 1.460-5 as direct labor costs." Under 26 CFR § 1.263A-1(b), some otherwise deductible costs are specifically excluded from capitalization under § 1.263A-1(e). For example, the follow items are carved out of the regulation:

- Costs of small resellers (<$10 million gross receipts)
- Costs incurred in certain farming businesses and timber businesses
- Intangible drilling and development costs
- Natural gas acquired for resale

Incorporating 26 CFR § 1.263A-1(e) by reference into Rule 3.588(d)(1) without addressing the carve outs in subsection 26 CFR § 1.263A-1(b) could create substantial confusion, especially for agriculture, exploration and production, and gas marketing industries. To remedy this confusion, we recommend the Comptroller clarify that costs of the type that would be capitalized or allocated under 26 CFR § 1.263A-1(e) qualify as direct labor costs regardless of whether the costs are exempted from § 263A by 26 CFR § 1.263A-1(b).

[4] Hereinafter, all references to CFR are to the Code of Federal Regulations.

C. Deductibility of Indirect or Administrative Overhead Costs under Proposed Rule § 3.558(f)

The Comptroller's description of "indirect or administrative overhead costs" in Proposed Rule § 3.588(f) appears to limit the category of items deductible pursuant to Tax Code § 171.1012(f). The statute provides that taxpayers "may subtract... indirect or administrative overhead costs, including all mixed service costs, including [various items]..." However, Proposed Rule § 3.588(f) refers merely to taxpayers' ability to subtract "those service costs, including mixed service costs...." We recommend the Comptroller clarify that "service costs" are just an example of one type of "indirect or administrative overhead costs".

Proposed Rule § 3.588(f) also specifies that allowable indirect or administrative overhead costs must be "properly" allocable to the acquisition or production of goods. There is no Tax Code requirement that such costs be "properly" allocable. We recommend the Comptroller eliminate the addition of the word "properly". Should the Comptroller decline to do so, we recommend as an alternative the Comptroller clarify that, for purposes of Proposed Rule 3.588(f), costs allocated by a reasonable allocation method as described in 26 CFR § 1.263A-1(f)(4) will be deemed to be properly allocated.

D. Clarification of Direct Costs at Rule § 3.588(d)(1)(A)

The term "1099 wages" used in defining labor costs in the prior version of Rule § 3.588 (at Rule § 3.588(d)(1)), is proposed to be moved to Proposed Rule § 3.588(d)(1)(A). We think the Comptroller intended the reference to "1099 wages" to include independent contractor payments for labor. With very limited exceptions "wages" are generally reportable on Internal Revenue Service Form W-2. Labor payments to independent contractors are typically not "wages" as the term is used for federal income tax purposes.

To avoid confusion, we suggest the following additional text be added to Proposed Rule § 3.588(d)(1)(A) to clarify the common understanding of 1099 labor costs and to clarify that such costs are includable in the determination of COGS:

> For purposes of this section, labor costs include W-2 wages, IRS Form 1099 wages ***and independent contractor payments for labor***, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses, such as per diem reimbursements for travel expenses and health insurance.

E. Modification to Allow Amendment to Elect Deduction of COGS

The Comptroller proposes to amend Rule 3.588(c)(3) (the "Deduction Change Provision") to read:

> A taxable entity, if eligible, must make an annual election to subtract cost of goods sold in computing margin by the due date, or at the time the report is filed, whichever is later. The election to subtract cost of goods sold is made by filing the franchise tax report using the cost of goods sold method. An amended report may be filed within the time allowed by Tax Code § 111.107 to change the method of computing margin from the cost of goods sold deduction method to the

compensation deduction method, 70% of total revenue, or, if otherwise qualified, the E-Z Computation method. See § 3.584 of this title (relating to Margin: Reports and Payments).

As indicated in the preamble to Proposed Rule 3.588, the Deduction Change Provision seeks to memorialize the Comptroller's recent change in policy that now allows taxable entities to change their originally-filed deduction election. The Comptroller's reconsidered position was also previously memorialized in STAR Accession No. 20120644L (June 12, 2012), which states:

> The Comptroller has reconsidered its position with regard to the election to take the cost of goods sold (COGS) or compensation deduction when filing an amended long form franchise tax report.
>
> Rule 3.584 Margin: Reports and Payments, provides that after the due date of the report an amended report may not be filed to change the method of computing margin to a COGS deduction or to a compensation deduction.
>
> The Comptroller has revised this policy to allow taxpayers to amend reports to change their election, or to make an election, to use the COGS or the compensation deduction. Taxpayers that elected to use the E-Z computation report or filed the no tax due information report may also amend to the long form and make an election to use the COGS or the compensation deduction. Taxpayers may file amended reports for any periods within the statute of limitations.
>
> This change in policy with regard to amending reports does not change the eligibility requirements that must be met in order to deduct COGS or compensation. See Rule 3.588 Margin: Cost of Goods Sold and Rule 3.589 Margin: Compensation.
>
> Rule 3.584 Margin: Reports and Payments will be amended to reflect this policy revision, and any appropriate adjustments will be made to the FAQs and STAR documents.

We commend the Comptroller's efforts of promulgating and updating Rules that are of broad interest to taxpayers. Accordingly, we agree with the Comptroller's office that its revised policy concerning the allowance of deduction election changes should be incorporated into the Rules. However, there are some issues that we perceive need to be clarified. We suggest the Proposed Rule § 3.588(c)(3) be further amended to address the following situations:

- *Deduction Change Provision Should Not Be Limited Solely to Rule § 3.588*. It is our understanding that the memorialization of the Comptroller's revised policy concerning deduction election changes is being made to Proposed Rule § 3.588, but not also to Rule § 3.589 (Compensation). We perceive that inclusion of the Deduction Change Provision in Proposed Rule § 3.588, without simultaneous inclusion in Rule § 3.589, could confuse taxpayers. For example, because Proposed Rule § 3.588 allows amended reports to be filed "to change the method of computing margin from the cost of goods sold deduction method to the compensation deduction method, 70% of total revenue, or, if otherwise qualified, the E-Z Computation method," taxpayers may believe there is no ability to make a change in election from compensation to COGS. We suggest the Deduction Change Provision be amended to clarify that taxpayers also have the ability to change their deduction election from compensation to COGS. Alternatively, or in addition, Rule § 3.589 could be amended simultaneously with amended Rule § 3.588 whereby amended Rule § 3.589 would contain the language necessary for taxpayers to make a deduction election change from compensation to COGS.

- *Cross Reference to Comptroller Rule § 3.584 Should Be Clarified*. STAR Accession No. 20120644L indicated that the Comptroller's revised policy concerning deduction election changes would be memorialized in an amendment to Rule § 3.584. Similarly, a posting on the Comptroller's website dated June 12, 2012, and titled Important Information Concerning Cost of Goods Sold (COGS) and Compensation Deduction Elections, also indicated that the Comptroller's revised policy concerning deduction election changes would be memorialized in an amendment to Rule § 3.584. It is our understanding that Rule § 3.584 is not simultaneously being amended along with Proposed Rule § 3.588. Rule § 3.584(f)(1) currently provides that "[a]fter the due date of the report, an amended report may not be filed to change the method of computing margin to a cost of goods sold deduction or to a compensation deduction." Until Rule § 3.584(f)(1) is amended, a cross reference to it within the Deduction Change Provision could confuse taxpayers because Rule § 3.584(f)(1), as it currently reads, explicitly disallows any change in deduction election. We suggest the cross reference to Rule § 3.584 in the Deduction Change Provision be deleted in order to avoid taxpayer confusion. Alternatively, Rule § 3.584(f)(1) could be amended simultaneously with Proposed Rule § 3.588.

- *Address Deduction Changes Resulting From Audits*. The Deduction Change Provision appears limited to the circumstance of taxpayers filing amended reports within the time allowed by Tax Code § 111.107. A deduction election change also can result, however, during a taxpayer audit. For example, a taxpayer that is a service provider might take the COGS deduction on its timely filed Texas Franchise Tax Report without knowing that it is not entitled to take the COGS deduction. Upon being audited, the taxpayer becomes aware of its mistake, agrees with the disallowance of the COGS deduction, and thereby seeks to change its election from COGS to compensation. In this audit example just described, an amended report would not be filed. Instead, the change from COGS to compensation would occur solely within the audit process. We do not perceive any reason why the Deduction Change Provision should not apply to all circumstances where a taxpayer will have a change in deduction election. Accordingly, we suggest the Deduction Change Provision be amended to clarify that it applies to deduction election changes made as a result of a Comptroller audit.

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IV. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope that these comments are helpful to you as you craft final changes relating to Rule § 3.588. Thank you for your consideration.