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The Texas Tax Lawyer

2015

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  Nikki L. Laing, Capshaw Green, PLLC

- Planning for New Basis At Death
  Mickey R. Davis, Davis & Willms, PLLC

COMMITTEE ON GOVERNMENT SUBMISSIONS:

- Comments on De Minimis Safe Harbor of Treas. Reg. § 1.263(a)-1(f)
  April 24, 2015
  Bruce A. McGovern, South Texas College of Law
  Shawn R. O'Brien, Mayer Brown
  Michael Threet, Haynes & Boone, LLP

The Chair's Message

Andrius R. Kontrimas

This has been another exciting year for the Tax Section. What better way to begin this message than with more exciting news. We are proud to recognize two Tax Section current members and past chairs who recently received national recognition. First, President Barack Obama recently announced his intent to nominate Elizabeth Ann Copeland as a Judge to the United States Tax Court. Elizabeth served as Chair of the Tax Section in 2013 – 2014 and currently serves on the Tax Section Council. She is a partner in the Tax Practice Group of Strasburger & Price, LLP in San Antonio, Texas.

Also, William H. Caudill has been honored with nomination as Chair-Elect of the American Bar Association's Section of Taxation. Bill will lead the ABA Tax Section, focused on serving its affiliates and the public through tax system education and leadership. He is a long-time member of the State Bar of Texas and the Tax Section. He served as chair of the Tax Section from 1991-1992. Bill is a partner with Norton Rose Fulbright in its Houston office.

The Tax Section has selected Sander "Sandy" Shapiro as the recipient of the 2015 Outstanding Texas Tax Lawyer Award. Sandy is recognized as a true Texas pioneer of tax practice at the Federal, state, and local levels. The award will be presented on June 19, 2015 at the Tax Section Annual meeting in San Antonio. Our luncheon program will feature Bill Elliott of Elliott, Thomason & Gibson, LLP interviewing Sandy about his exceptional career. More information here.

In January, we graduated 19 participants in our second Leadership Academy class. The Tax Section Leadership Academy is designed to guide the next generation of Texas tax lawyers by providing participants with opportunities to get involved in Tax Section leadership committees, one-on-one mentoring, educational programs, and networking opportunities. Thanks to Dan Baucum and David Colmenero for leading this year's class. Our next Leadership Academy will take place in 2016 – 2017 with Christi Mondrik as Co-Chair with the assistance of Dan Baucum as Co-Chair. Applications for the next Leadership Academy program will be available in Fall 2015.

This has been a busy and productive year for the Committee on Government Submissions (COGS). A very big Texas-size thank you to Bob Probasco for his leadership as Chair of this important and very active committee. To date in the 2014 – 2015 year, COGS has filed ten comments letters, assisted the Real Estate Probate and Trust Law section with a draft bill for the Texas legislature, and participated in one public hearing. Recently submitted comments are included in this publication. Current and previous comment letters are available on the Tax Section website.

The Tax Section continued its award winning pro bono program of assisting pro se litigants during United States Tax Court calendar calls throughout Texas in the cities of Dallas, El Paso, Houston, Lubbock, and San Antonio. This year, we assisted approximately 40 taxpayers with cases pending in the United States Tax Court. Our Tax Court pro bono program was the first statewide program of its kind in the nation. Many thanks to Juan F. Vasquez, Jr., the Pro Bono Committee Chair, and his Vice Chairs, Vicki L. Rees, Derek Matta, and Joe Perera, for their outstanding work in coordinating our pro bono efforts.

The Tax Section also continued its long-standing tradition of providing many live CLE events for our members and others interested in tax law. Our live CLE events included our basics course, Tax Law in a Day, held in Dallas; the International Tax Symposium presented in Plano and Houston; the Annual

Property Tax Conference held in Austin; the Annual Texas Comptroller's Meeting, co-sponsored with TSCPA and TEI, held in Austin; and the Advanced Tax Law Course to be held this Fall, in which the Tax Section serves as a co-sponsor with TexasBarCLE. Special thanks to the program directors of these courses: Lora Davis, Austin Carlson, Melinda Blackwell, Charolette Noel, Jim Roberts, and Amanda Traphagan.

We also have an outstanding lineup for the Tax Section Annual Meeting in San Antonio. Special thanks to Jaime F. Vasquez, Chair of the Annual Meeting Committee, and his Vice Chair, Matt Larsen, for all of their help in coordinating our Annual Meeting program. Our live CLE programs, as well as our free 24/7 CLE audio/video library is overseen by our Continuing Legal Education Committee. Special thanks to Committee Chair, Michael Threet, and his vice chairs, Amanda Traphagan and Jim Roberts, for keeping our CLE programming relevant and up to date.

Each year, through our Law Student Outreach Committee, the Tax Section visits law schools and hosts a "Tax Career Day" panel presentation where tax lawyers discuss what they do in the various specialized tax fields and answer student questions on a career in tax law. This year we held luncheons at: Baylor University, SMU Dedman School of Law, Texas Tech University School of Law, LSU-Paul M. Herbert Law Center, University of Texas School of Law, South Texas College of Law, and Texas A&M University School of Law.

Our Law Student Outreach Committee also oversees our law student scholarship program. Through this program, we awarded four $2,000 scholarships this year to law students demonstrating academic excellence and commitment to the practice of tax law in Texas. The scholarship recipients for the 2014-2015 year are: Neil Clausen (University of Virginia School of Law); Ryan Phelps (University of Texas School of Law); Kelsey M. Taylor (SMU Dedman School of Law); and Samantha Lynn Coleman (St. Mary's University School of Law). Special thanks to Abbey B. Garber, Lisa Rossmiller, and Jeff Blair for spearheading and overseeing our Law Student Outreach Committee.

We are completing work on the new website and preparing to launch it next month in June 2015! When launched, you will immediately notice the site's fresh design, striking colors, and creative use of images. We have also reorganized the site to make it easier to find the information you need, included a member search function, and developed tools to support council and committee business.

Developing – and in the future, maintaining -- the new Tax Section website has been a team effort. Thanks to Alyson Outenreath, Tax Section Chair-Elect, and Vicki McCullough, Section Administrator, for working closely with the development process. Also, our thanks to SBOT Sections staff Tracy Nuckols and Michelle Bracken and to Joe Savoy and Dustin Thomas with our web design provider First Step Internet.

My thanks to each of you for being part of the Tax Section. This is an exceptional group of tax lawyers and I appreciate the opportunity to serve as Tax Section Chair. I look forward to seeing all of you at our Annual Meeting on June 19, 2015.

Andrius R. Kontrimas, Tax Section Chair

TAX SECTION
THE STATE BAR OF TEXAS

LEADERSHIP ROSTER

2014 - 2015

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THE STATE BAR OF TEXAS

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TAX SECTION
OF
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2014-2015
CALENDAR

June 2014	
1	**Deadline for Student Scholarship Applications**
11-13	**30th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio**
17	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
26-27	**SBOT 2014 Annual Meeting - Austin Convention Center**
26	**Council Retreat** Hosted by: Norton Rose Fulbright (Andrius R. Kontrimas) 98 San Jacinto Boulevard, Suite 1100 Austin, TX 78701-4255 Telephone: +1 512 474 5201 2:00 pm – 5:00 pm
25-27	**Leadership Academy - Austin** Hosted by: Jackson Walker 100 Congress Avenue, Suite 1100 Austin, Texas 78701 Telephone: +1 512 236 2000
27	**Tax Section Annual Meeting** Austin Convention Center 8:00 am – 4:40 pm (post on website at least ***20 days in advance***; elect 3 new Council members)
July 2014	
22	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am

August 2014	
1	**Scholarship Program** Review and revise scholarship applications; submit changes to Tax Section for approval.
1	**Bar Leaders Conference – New Chair and Treasurer Orientation** Westin Domain – Houston 10:30 a.m. – 2:30 p.m.
8-10	**ABA Annual Meeting** Boston, Massachusetts
19	**Officer Retreat** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 11:30 a.m. – 3:30 p.m.
19	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
28-29	**32nd Annual Advanced Tax Law Course** co-sponsored by the State Bar of Texas Tax Section. Westin Galleria Hotel Dallas, Texas
September 2014	
5	**Council and Committee Chairs and Vice Chairs Meeting** **MANDATORY IN PERSON ATTENDANCE** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 10:30 a.m. – 12:30 p.m.

15-16	**Pro Bono Committee Calendar Call Assistance (regular and small case)** United States Tax Court Lubbock, Texas
18-19	**Pro Bono Committee Calendar Call Assistance (regular and small case)** United States Tax Court El Paso, Texas
18-20	**ABA Joint Fall CLE Meeting** Sheraton Downtown Denver, Colorado
23	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
25 – 26	**Leadership Academy Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 8:15 a.m. – 4:45 p.m.
27	**Deadline for appointing Nominating Committee (list in Texas Tax Lawyer and on website)**
October 2014	
3	**Submission Deadline - Fall 2014 Issue of the Texas Tax Lawyer**
21	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
24	**Council of Chairs Meeting** Texas Law Center in Austin 10:30 am – 2:30 pm
27	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court San Antonio, Texas

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November 2014	
1	**Scholarship Program** Verify email addresses of law school contacts and professors for purposes of creating the master distribution list.
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
5	**Open nominations for Outstanding Texas Tax Lawyer. Nominations due January 15, 2015.**
6	**18th Annual International Tax Symposium – Plano, Texas** **The Center for American and International Law** **5201 Democracy Drive** **Plano, Texas 75024**
7	**18th Annual International Tax Symposium – Houston, Texas** **The Hess Club** **5430 Westheimer Road** **Houston, Texas**
7	**Council Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 10:30 a.m. – 12:30 p.m.
18	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
December 2014	
1 and 8	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Houston, Texas

1 and 8	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
16	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
31	**Scholarship Program** Verify email addresses of law school contacts and professors for purposes of creating the master distribution list.
January 2015	
15	**Leadership Academy Meeting** Dallas Bar Association – Belo Mansion Dallas, Texas
15	**Deadline for annual meeting program agenda** Nominations due for Outstanding Texas Tax Lawyer Open nominations for Officers and Elected Council (Council vote follows January 16th meeting)
20	**Scholarship Program** o Email applications to law schools; o Post application on Tax Section website; and o Email applications to tax law professors.
20	**COGS Call** 9:00 am
29	**Council and Committee Chairs and Vice Chairs Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 3:00 pm – 5:00 pm
29-31	**ABA Mid-Year Meeting** Hilton Americas Houston, Texas
February 2015	
6	**Submissions Deadline – Winter 2015 issue of the *Texas Tax Lawyer***

6	**Tax Law in a Day** Cityplace Dallas Tx
14	**Tax Court Pro Bono Program Annual Renewal**
17	**COGS Call** 9:00 am
20	**Council of Chairs Meeting** Texas Law Center in Austin 10:30 am – 2:30 pm
March 2015	
1	**Nominations deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
24	**COGS Call** 9:00 am
April 2015	
1	**Nominating Committee's Report** due to Council (Must be submitted at least 10 days before April 17, 2015 Council meeting).
3	**Scholarship Program** Deadline for submission of completed applications.
10	**Scholarship Program** Scholarship Committee meets to discuss and select scholarship recipients.
13	**Property Tax Conference** Thompson Conference Center Austin, Texas
17	**Council Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 Elect Chair-Elect, Secretary, and Treasurer 10:30 a.m. – 12:30 p.m.
21	**COGS Call** 9:00 am
24	**Submissions Deadline – Spring 2015 issue of the Texas Tax Lawyer**

May 2015	o
1	**Scholarship Program** o Contact recipients of the scholarships; and Send email notifications to individuals not selected.
7-9	**ABA May Meeting** Grand Hyatt Washington, DC
19	**COGS Call** 9:00 am
June 2015	
10-12	**31st Annual Texas Federal Tax Institute – San Antonio, Texas** Hyatt Regency Hill Country
	Council Retreat – San Antonio, Texas 1:00 – 4:00 pm Location and details to be announced
18-19	**SBOT 2015 Annual Meeting – San Antonio, Texas** Henry B. Gonzales Convention Center/Grand Hyatt Hotel SBOT Annual Meeting Tax Section Annual Meeting
19	**Scholarship Program** Award of Scholarships at State Bar Annual Meeting.
23	**COGS Call** 9:00 am
July & Aug 2015	
30-4	**ABA Annual Meeting** Chicago, Ill
Sept 2015	
17-19	**ABA Joint Fall Meeting** Sheraton Hotel & Towers Chicago, Ill

Nuts and Bolts of Unrelated Business Income Tax

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Nuts and Bolts of Unrelated Business Income Tax

I. Introduction. This paper summarizes the unrelated business income tax rules as they apply to tax-exempt charitable organizations described in Section 501(c)(3) of the Code.[1] Since the 1950s, the unrelated business income tax has been imposed on a charity's net income from a regularly carried on trade or business that is unrelated to the charity's tax-exempt purposes. Often times, the justification for imposing this tax on a charity's net income from unrelated business activities is that such activities involve unfair competition with the charity's for-profit counterparts.[2]

II. Unrelated Business Income Tax ("UBIT"): General Rules.[3]

A. Definition of Unrelated Business. Organizations described in Section 501(c)(3) of the Code are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.[4] The term "unrelated trade or business" means an activity conducted by a tax-exempt organization which is regularly carried on[5] for the production of income from the sale of goods or performance of services[6] and which is not substantially related to the performance of the organization's charitable, educational or other exempt functions.[7]

1. Activity is a "Trade or Business." For purposes of the unrelated business income tax regime, "the term 'trade or business' has the same meaning it has in Section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."[8] Section 162 of the Code governs the deductibility of trade or business expenses. In that context, the U.S. Supreme Court has declared that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[9] When applying this test, the IRS may take into account a key purpose of the unrelated business income tax: to prevent unfair competition between taxable and tax-exempt entities. "[W]here an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in

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[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.
[2] *See* Treas. Reg. § 1.513-1(b) ("The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.").
[3] Portions of this discussion on unrelated business income are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

[4] *See* I.R.C. § 511.

[5] Treas. Reg. § 1.513-1(a).

[6] I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).

[7] I.R.C. § 513(a).
[8] Treas. Reg. § 1.513-1(b).
[9] Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

competition with taxable organizations."[10] However, the mere fact that the activity is conducted as a fund-raising activity of the charity is not sufficient to conclude that the activity is not a trade or business.[11]

The most important element as to whether the activity is a trade or business is the presence of a profit motive. In the context of a tax-exempt organization, the U.S. Supreme Court declared that the inquiry should be whether the activity "'was entered into with the dominant hope and intent of realizing a profit.'"[12] Significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.[13] When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive.[14] An activity that produces consistent losses may indicate that no profit motive exists, and therefore the activity is not a trade or business. This determination may prevent an exempt organization from offsetting UBTI from profitable activities with losses from a consistently unprofitable activity.

2. Regularly Carried On Requirement. In general, in determining whether a trade or business is "regularly carried on," one must consider the frequency and continuity with which the activities productive of income are conducted, and the manner in which they are pursued. Business activities are deemed to be "'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[15] For example, "[w]here income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business *[sic]*."[16] Similarly, "income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically."[17] However, "[w]here income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business."[18]

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[10] Treas. Reg. § 1.513-1(b). *But see* La. Credit Union League v. United States, 693 F.2d 525, 542 (5th Cir. 1982) ("[T]he presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to be taxed.").

[11] *See Am. Bar Endowment*, 477 U.S. at 115 (stating that a charity cannot escape taxation by characterizing an activity as fundraising, because otherwise "any exempt organization could engage in a tax-free business by 'giving away' its product in return for a 'contribution' equal to the market value of the product").

[12] United States v. Am. Bar Endowment, 477 U.S. 105, 110, n. 1 (1986) (quoting Brannen v. Comm'r, 722 F.2d 695, 704 (11th Cir. 1984).

[13] Ill. Ass'n of Prof'l Ins. Agents v. Comm'r, 801 F.2d 987, 992 (7th Cir. 1986).

[14] *See, e.g.*, Carolinas Farm & Power Equip. Dealers Ass'n, Inc. v. United States, 699 F.2d 167, 170 (4th Cir. 1983) ("[T]here is no better objective measure of an organization's motive for conducting an activity than the ends it achieves."); La. Credit Union League v. United States, 693 F.2d 525, 533 (5th Cir. 1982) (finding that a profit motive existed based on the fact that the organization was extensively involved in endorsing and administering an insurance program that proved highly profitable); Fraternal Order of Police Ill. State Troopers Lodge No. 41 v. Comm'r, 87 T.C. 747, 756 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987) (reasoning that the organization's advertising activities were "obviously conducted with a profit motive" because the activities were highly lucrative and with no risk or expense to the organization).

[15] Treas. Reg. § 1.513-1(c)(1).

[16] Treas. Reg. § 1.513-1(c)(2)(i).

[17] Treas. Reg. § 1.513-1(c)(2)(iii).

[18] Treas. Reg. § 1.513-1(c)(2)(i).

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In making this determination, it is essential to identify the appropriate nonexempt commercial counterpart to the exempt organization's activity, because the manner in which the nonexempt commercial counterpart conducts its similar activities has an important bearing on whether the activity is considered to be carried on year-round, on a seasonal basis or intermittently. For example, a tax-exempt organization's annual Christmas card sales program was determined to be regularly carried on when conducted over several months during the holiday season because, although nonexempt organizations normally conduct the sale of greeting cards year-round, the Christmas card portion of the nonexempt organizations' sales was conducted over the same seasonal period.[19] By contrast, when an exempt organization's fundraising activities are conducted on an intermittent basis, such activities are generally considered not to be regularly carried on.[20]

If an exempt organization's engages in business activities intermittently, such activities will not be considered regularly carried when such activities are conducted without the competitive and promotional efforts of commercial endeavors. For example, the sale of candy bars at a university bookstore are not treated as regularly carried on under this casual sale exception even though conducted year round because the sale is incidental to the sale of textbooks and other educational supplies to students.[21]

Furthermore, in determining whether an exempt organization's business activities are "regularly carried on," the activities of the organization's agents may be taken into account.[22] Courts disagree as to whether an exempt organization's preparation time in organizing and developing an income-producing activity may be taken into account.[23]

3. Unrelated to the Charity's Exempt Purpose. In the event the charity's activities are determined to be regularly carried on, the next inquiry is whether such activities are related to the charity's purposes which constitute the basis for its exemption.[24] This in an inherently factual determination. To determine whether the business activity is "related," the relationship between the conduct of the business activities that generate the income and the accomplishment of the organization's exempt purposes must be examined to determine whether a causal relationship exists.[25] The activity will not be substantially related merely because the

[19] Veterans of Foreign Wars, Dept. of Mich. v. Comm'r, 89 T.C. 7, 32-37 (1987).

[20] *See* Treas. Reg. § 1.513-1(c)(2)(iii) (stating fundraising activities lasting only a short period of time will generally not be regarded as regularly carried on, despite their recurrence or their manner of conduct); Suffolk County Patrolmen's Benevolent Ass'n, Inc. v. Comm'r, 77 T.C. 1314 (1981), *acq.*, 1984-2 C.B. 2 (determining that the conduct of an annual vaudeville show one weekend per year and the solicitation and publication of advertising in the related program guide which lasted eight to sixteen weeks per year was intermittent and not regularly carried on). *Cf*. Treas. Reg. § 1.513-1(c)(2)(ii) ("[E]xempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.")

[21] Treas. Reg. § 1.513-1(c)(2)(ii)

[22] State Police Ass'n of Mass. v. Comm'r, 72 T.C.M. (CCH) 582 (1996), *aff'd*, 125 F.3d 1 (1st Cir. 1997).

[23] *See* Nat'l Collegiate Athletic Ass'n v. Comm'r, 92 T.C. 456 (1989) (finding that NCAA's sale of advertisements for annual championship program was "regularly carried on," in part because of the amount of preliminary time spent to solicit advertisements and prepare them for publication), *rev'd*, 914 F.2d 1417 (10th Cir. 1990) (holding that this activity was not regularly carried on, because only the time spent conducting the activity, not the time spent in preparations, is relevant to that determination); A.O.D. 1991-015 (indicating that the IRS will continue to litigate the issue).

[24] *See* Treas. Reg. § 1.513-1(d)(1).

income produced from the activity is used to further the organization's exempt purposes.[26] Rather, the inquiry focuses on the manner in which the income is earned. Thus, a substantial causal relationship exists if the distribution of the goods from which the income is derived contributes importantly to the accomplishment of the organization's exempt purposes.[27] In each case, the determination of whether this relationship exists depends on the facts and circumstances involved.

In making this determination, the scale and scope of the activities involved are considered in relation to the nature and extent of the exempt functions they are serving.[28] If the activities are conducted on a scale larger than is reasonably necessary to accomplish the exempt purposes, the income attributed to the excess activities constitutes unrelated business income.[29] Additionally, the sale of a product resulting from the performance of an exempt function will not produce UBTI to the extent it is sold in substantially the same state as it was on completion of the exempt function.[30] But, if the product is exploited beyond that reasonably necessary to sell it upon completion of the exempt function, the income from the sale would be UBTI.[31] For example, assume an exempt charitable organization operated for scientific purposes sells milk and cream from an experimental dairy herd. Since this is a sale of the byproduct of the organization's exempt activity, it does not create UBTI. However, if the organization were to use the milk and cream to manufacture ice cream, pastries and other food items, the gross income from the sale of such products would be UBTI unless the manufacturing activities themselves contribute importantly to the accomplishment of the exempt purpose of the organization.[32]

Moreover, if an exempt organization creates goodwill or another intangible that is capable of being exploited in a commercial manner, the exempt organization still must complete the UBTI analysis.[33] Just because the intellectual property was created via an exempt activity does not make any income from its exploitation exempt. For example, a university sponsors professional orchestras on its campus during the school year. Both students and members of the general public may purchase tickets from the university. Although the presentation for the performance makes use of an intangible generated by the university's exempt educational functions, i.e., the presence of the student body and faculty, the presentation of such music event contributes importantly to the overall educational and cultural function of the university.[34] However, when an exempt scientific organization endorses laboratory equipment in return for money, the income derived for the sale of endorsements is UBTI.[35]

Under the fragmentation rule, a business activity still may be considered an unrelated trade or business even though it is carried on within the broader scope of similar activities that are

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[25] Treas. Reg. § 1.513-1(d)(1).

[26] I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(1).

[27] Treas. Reg. § 1.513-1(d)(2).

[28] *See* I.R.C. § 511.

[29] *Id*.
[30] Treas. Reg. § 1.513-1(d)(4)(ii).
[31] *Id*.
[32] *Id*.
[33] Treas. Reg. § 1.513-1(d)(4)(iv).
[34] *Id*. at Ex. 2.
[35] *Id*. at Ex. 1.

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related to the organization's exempt purpose.[36] For example, pharmaceutical sales by a hospital to non-patients does not fail to constitute a trade or business merely because the hospital also sells drugs to its patients. Similarly, sales by a museum gift shop are evaluated on an item by item basis to determine if the sale of each item contributes importantly to the museum's exempt purpose. Accordingly, sales of reprints of art displayed in the museum would relate to the museum's exempt purpose, but sales of logo t-shirts by the museum gift shop would not.

Even if an asset is used primarily in furtherance of an organization's exempt purpose, it may still generate UBTI if its use is not substantially related to exempt purpose.[37] For example, a museum does not have UBTI when it operates a theatre during regular museum hours and shows artistic and educational films. However, if the museum operates the theatre as an ordinary motion picture theatre with mainstream Hollywood movies for public entertainment during evening hours when the museum is closed, gross income from the motion picture ticket sales would be from the conduct of an unrelated trade or business.[38]

II. Exceptions and Modifications.

A. Statutory Exceptions. The term "unrelated trade or business" is subject to several exceptions under which certain businesses that may otherwise constitute unrelated businesses are removed from the scope of the tax. In particular, the term "unrelated trade or business" does not include a trade or business in which substantially all the work in carrying on the trade or business is performed for an organization without compensation.[39] Unlike the other exceptions, the "volunteer exception" is not restricted as to the nature of the businesses to which it pertains. Also, an activity by an exempt organization which is carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees is excluded from the term "unrelated trade or business."[40] In addition, the term "unrelated trade or business" does not include the trade or business of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.[41] Finally, an exception from the unrelated business income tax is also provided for income derived from the distribution of low cost articles incident to the solicitation of charitable contributions.[42]

B. Modifications for Passive Activities Generally. The purpose of the unrelated business income tax is to eliminate the conduct of unrelated businesses by tax exempt organizations as a source of unfair competition with for-profit companies. To the extent that income of a tax exempt organization is derived from investment and other passive activities, the taxation of such income is not necessary to accomplish this goal. Accordingly, the modifications to the unrelated business income tax exclude most passive income, as well as the deductions associated with such

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36 I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).
37 Treas. Reg. § 1.513-1(d)(4)(iii).
38 *Id*.
39 I.R.C. § 513(a)(1).
40 I.R.C. § 513(a)(2).
41 I.R.C. § 513(a)(3).
42 I.R.C. § 513(h). For tax years beginning in 2015, a low-cost article is one which has a cost to the organization of $10.50 or less. Rev. Proc. 2014-16. There are several other exceptions including, but not limited, certain entertainment activities, trade shows, hospital cooperative services and bingo games. *See* I.R.C. §§ 513(d)(1), (2), (3); § 513(e); § 513(f).

passive income, from the scope of the tax.[43] In particular, the following types of passive income are excluded from unrelated business taxable income:

i. dividends;[44]
ii. interest;[45]
iii. annuities;[46]
iv. payments with respect to securities loans;[47]
v. amounts received or accrued as consideration for entering into agreements to make loans;[48]
vi. royalties;[49]
vii. gains or losses from the sale, exchange, or other disposition of property other than inventory;[50] and
viii. gains or losses recognized in connection with a charitable organization's investment activities from the lapse or termination of options to buy or sell securities or real property.[51]

1. Rents. In addition, certain rents are excluded from unrelated business taxable income.[52] The exclusion applies to rents from real property and rents from personal property leased with such real property, provided that the rents attributable to the personal property are an incidental amount of the total rents received or accrued under the lease.[53] Three principal exceptions limit the ability of a charitable organization to exclude the eligible rents described above from unrelated business taxable income. The exceptions apply when there are excessive personal property rents, when rent is determined by net profits from the property, and when certain services are rendered to the lessee. Under the first exception, the rental exclusion does not apply if more than 50% of the total rent received or accrued under the lease is attributable to personal property, determined at the time the personal property is first placed in service.[54] Under the second exception, the rental exclusion is not available if the determination of the amount of rent depends in whole or in part on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage or percentages of receipts or sales.[55] Under the third exception, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant do not constitute rent from real property.[56] As a

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43 *See generally* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).
44 I.R.C. § 512(b)(1).
45 I.R.C. § 512(b)(1).
46 I.R.C. § 512(b)(1).
47 I.R.C. § 512(b)(1). The term "payments with respect to securities loans," refers to income derived from a securities lending transaction in which an exempt organization loans securities from its portfolio to a broker in exchange for collateral. I.R.C. § 512(a)(5). Payments derived from a securities lending transaction typically include interest earned on the collateral and dividends or interest paid on the loaned securities while in the possession of the broker.
48 I.R.C. § 512(b)(1).
49 I.R.C. § 512(b)(2). A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name or copyright. Rev. Rul. 81-178, 1981-2 C.B. 135. By contrast, the payment for personal services does not constitute a royalty. *Id.*
50 I.R.C. § 512(b)(5).
51 I.R.C. § 512(b)(5).
52 I.R.C. § 512(b)(3).
53 I.R.C. § 512(b)(3)(A).
54 I.R.C. § 512(b)(3)(B)(i).
55 I.R.C. § 512(b)(3)(B)(ii).
56 Treas. Reg. § 1.512(b)-1(c)(5).

general rule, services are considered to be rendered to the occupant if the services are (a) primarily for the convenience of the occupant, and (2) other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.[57]

2. Royalties. Because royalties are passive in nature, the receipt of royalty income by a tax-exempt organization does not result in unfair competition with taxable entities.[58] Accordingly, section 512 of the Code provides that a charity's UBTI generally does not include royalties.[59] A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name, or copyright.[60] The royalty may be in the form of a fixed fee or a percentage of sales of the products bearing the charity's name and logo. In addition, the tax-exempt organization may retain the right to approve the use of its name or logo without changing the determination that the income from the transaction is a royalty.

Of particular importance in the royalty context is the amount of services the charity performs in exchange for the payment received. In order to maintain the royalty exemption for the payments received, the charity may not perform more than *de minimis* services in connection with the arrangement.[61] If the charity performs more than insubstantial services, then the income received is considered compensation for personal services, the royalty exception would not apply, and the income would most likely be subject to tax as UBTI.[62]

For example, the Internal Revenue Service privately ruled that royalties received by a charity from the license of the charity's intellectual property to a for-profit company for use in the company's commercial activities were excluded from the charity's UBTI under the royalty exception.[63] Under the license agreement, the charity retained the right to review the designs and proposed uses of the charity's intellectual property, inspect the commercial counterpart's facilities where the product was manufactured, and inspect the commercial counterpart's books and records annually. The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were *de minimis*. Moreover, the licensing agreement was narrowly tailored to protect the charity's ownership of its intellectual property by giving the charity absolute discretion to reject proposed uses of the property, providing notice on every unit displaying the charity's mark that it was used with the charity's permission, and allowing the charity to approve and limit mass media advertising of the product. The Internal Revenue Service concluded that the income that the charity would receive from the arrangement was "vastly out of proportion with the time and effort" the charity would expend. Therefore, it could only be compensation for the use of the charity's intellectual property.

The determination of the permissible amount of "insubstantial services" is uncertain, however, especially in connection with the charitable organization's exercise of quality control over the use of its name, logo, and trademarks. As is prudent business practice, a charity would want to maintain quality control over the use of its name, logo, and trademark by the corporate partner under the licensing agreement. In some cases, the Internal Revenue Service has

[57] *Id*.
[58] *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1533 (9th Cir. 1996).
[59] I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). A charity's UBTI would include royalties derived from debt-financed property. Treas. Reg. § 1.512(b)-1(b).
[60] Rev. Rul. 81-178, 1981-2 C.B. 135.
[61] *Sierra Club*, 86 F.3d at 1533–35.
[62] *See* Rev. Rul. 81-178.
[63] Priv. Ltr. Rul. 200601033 (Oct. 14, 2005).

determined that "mere" quality control does not constitute more than insubstantial services related to the royalty income.[64] In other cases, a charity's "quality control" was recharacterized as services, resulting in the income from the arrangement being taxed as compensation from services rather than exempted as royalty income.[65] Therefore, charities are left to struggle with the determination of the permissible types of "quality control" they can include in their licensing agreements without crossing the boundary between *de minimis* and substantial services.

Furthermore, caution should be taken in relying on the royalty exception for income received from the licensing of a charity's name or logo for placement on a corporate sponsor's product. In evaluating the justification for the continued tax exemption for college athletic programs, the Congressional Budget Office recommended repealing the royalty exception to the extent that it applies to the licensing of a charity's name or logo:

> Some types of royalty income may reasonably be considered more commercial than others. . . . [W]hen colleges and universities license team names, mottoes, and other trademarks to for-profit businesses that supply apparel, accessories, and credit cards to the general public, they approve each product and use of their symbols and, in some cases, exchange information, such as donor lists, with the licensees to aid in their marketing. . . . The manufacture or sale of such items would clearly be commercial—and subject to the UBIT—if undertaken directly by the schools. Schools' active involvement in generating licensing income could be the basis for considering such income as commercial and therefore subject to the UBTI. . . .
>
> Bringing royalty income that accrues only to athletic departments under the UBIT would be problematic, however . . . . [I]f royalty income from licensing team names to for-profit businesses was truly considered commercial and subject to the UBIT, the same arguments would apply in full force to licensing all other university names and trademarks. A consistent policy would subject all such income to the UBIT because of its commercial nature. Such a change in policy could affect many other nonprofits in addition to colleges and universities . . . .[66]

C. <u>Corporate Sponsorships</u>. Under section 513(i) of the Internal Revenue Code, the receipt of qualified sponsorship payments by a charity does not constitute the receipt of income from an unrelated trade or business, and instead, the payment is treated as a charitable contribution to the charity.[67] A "qualified sponsorship payment" is "any payment[68] by any person engaged in a trade or business with respect to which there is no arrangement or expectation that

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[64] *See, e.g.*, Rev. Rul. 81-178, 1981-2 C.B. 135; Priv. Ltr. Rul. 200601033 (Oct. 14, 2005); Priv. Ltr. Rul. 9029047 (Apr. 27, 1990)

[65] *See, e.g.*, NCAA v. Comm'r, 92 T.C. 456, 468–70 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990); Fraternal Order of Police v. Comm'r, 87 T.C. 747, 758 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987).

[66] CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS 13 (2009).

[67] I.R.C. § 513(i); Treas. Reg. § 1.513-4(a). The Treasury Regulations provide the following example of a qualified sponsorship payment:

> M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to the winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgement of the sponsorship.

Id. § 1.513-4(f), example 1.

[68] "Payment" means "the payment of money, transfer of property, or performance of services." *Id.* § 1.513-4(c)(1).

the person will receive any substantial return benefit."[69] A "substantial return benefit" is any benefit other than a "use or acknowledgement"[70] of the corporate sponsor and certain disregarded benefits.[71] Substantial benefits include the charitable organization's provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships;[72] and any license to use intangible assets of the charitable organization.[73] "If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment."[74] The exempt organization has the burden of establishing the fair market value of the substantial return benefit. If the organization fails to do so, "no portion of the payment constitutes a qualified sponsorship payment."[75]

The following examples from the Treasury Regulations illustrate the application of the substantial return benefit rule.

N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation's support by using the corporate name and established logo in materials publicizing the exhibition, which includes banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2% of the total payment. N's use of the corporate name and logo in connection with the exhibition constitutes acknowledgement of the sponsorship. However, because the fair market value of the dinner exceeds 2% of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.[76]

X, a health-based charity, sponsors a year-long initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X's website. X's website contains

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69 *Id*. For purposes of these rules, it is irrelevant whether the sponsored activity is temporary or permanent. *Id*

70 The permitted "uses or acknowledgements" under the qualified sponsorship payment rules include (i) "logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company," (ii) "a list of the payor's locations, telephone numbers, or Internet address," (iii) "value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services," and (iv) "the payor's brand or trade names and product or service listings." *Id.* § 1.513-4(c)(1)(iv). "Logos or slogans that are an established part of the payor's identity are not considered to contain qualitative or comparative descriptions." *Id.*

71 *Id.* § 1.513-4(c)(2). A benefit is disregarded if "the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than two percent of the amount of the payment." *Id.* § 1.513-4(c)(2)(ii). If this limit is exceeded, the entire benefit (and not just the amount exceeding the two percent threshold) provided to the payor is a substantial return benefit. *Id.*

72 The Treasury Regulations define an "exclusive provider" relationship as any arrangement which "limits the sale, distribution, availability, or use of competing products, services or facilities in connection with an exempt organization's activity." *Id.* § 1.513-4(c)(2)(vi)(B). "For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit." *Id.*

73 *Id.* § 1.513-4(c)(2)(iii)(D).

74 *Id.* § 1.513-4(d).

75 *Id.*

76 Treas. Reg. § 1.513-4(f) (Ex. 2).

a hyperlink to the pharmaceutical company's website. On the pharmaceutical company's website, the statement appears, "X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition." X reviewed the endorsement before it was posted on the pharmaceutical company's website and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company's website is a qualified sponsorship payment.[77]

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBIT principles.[78] The mere fact that the payments are received in connection with the corporate sponsor receiving a substantial return benefit does not necessitate the payments constituting UBTI. For example, in a memorandum released by the Internal Revenue Service in October 2001, examples of certain exclusive provider relationships were addressed.[79] Significantly, one example involved a contract between a soft drink company and a university, under which the soft drink company would be the exclusive provider of soft drinks on campus in return for an annual payment made to the university. Exclusive provider relationships are explicitly named as a substantial return benefit; therefore, the arrangement did not qualify as a qualified sponsorship payment. Because the soft drink company maintained the vending machines, there was no obligation by the university to perform any services on behalf of the soft drink company or to perform any services in connection with the contract. Accordingly, the university did not have the level of activity necessary to constitute a trade or business. Since the contract also provided that the soft drink company was given a license to market its products using the university's name and logo, the portion of the total payment attributable to the value of the license would be excluded from the university's UBTI as a royalty payment.

If the corporate sponsorship involves the charity's endorsement of the corporate sponsor's product or services, then the income from the corporate sponsorship will likely be included in the charity's UBTI as advertising income. "Advertising" is "any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product."[80] Advertising includes "messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product."[81] For example, the Internal

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[77] *Id.* at Ex. 12.
[78] *Id.* § 1.513-4(f).
[79] *See IRS Issues Field Memo on Exclusive Providers and UBIT*, 2001 TAX NOTES TODAY 192-26 (Oct. 3, 2001).
[80] Treas. Reg. § 1.513-4(c)(v).
[81] *Id.* Typically, advertising is considered to be a trade or business that is unrelated to the charity's exempt purposes. Thus, the question remains whether the advertising activity is "regularly carried on." If advertising messages of a corporate sponsor's product are continuously present on the charity's website, such advertising activities would seem to be regularly carried on and the revenues therefrom would thus constitute UBTI. One counter-argument would appear to be that the limited number of advertisements makes the charity's activities dissimilar in extent to comparable commercial activities. *See* Tech. Adv. Mem. 9417003 (Dec. 31, 1993) (stating that an advertising campaign conducted by placing advertisements in programs for an organization's annual ball was not typical of commercial endeavors because solicitations for advertisements were limited in number and consisted of a single form letter). Given the variety and relative novelty of Internet advertisements, it would be unwise for a charity to rely upon such a position. *See generally* I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385 (announcing that the Internal

Revenue Service considers the following messages to consist, at least in part, of advertising: (i) "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call at 555-1234. This station is proud to have the Music Shop as a sponsor,"[82] and (ii) "Visit the Music Shop today for the finest selection of music CDs and cassette tapes."[83] If a single message contains both advertising and an acknowledgement, the message is an advertisement. Where the Treasury Regulations do not allow one to clearly distinguish between advertisements and permitted uses and acknowledgements, a court may be inclined to take a common-sense approach and consider a message an advertisement if it "looks like" an ad.[84]

The United States Supreme Court considered whether advertising could be substantially related to an organization's exempt purposes in *United States v. American College of Physicians*,[85] the leading case on this topic. There, an exempt physicians' organization received income from the sale of advertising in its professional journal. The messages in question consisted of advertisements for "pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine." The organization "has a long-standing practice of accepting only advertisements containing information about the use of medical products, and screens proffered advertisements for accuracy and relevance to internal medicine." The organization argued that these advertisements were substantially related to its exempt functions because they contributed to the education of the journal's readers. At trial, experts testified that "drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture and use."[86] Rejecting the organization's claim and ruling that the advertising income was UBTI, the Supreme Court analyzed this issue as follows:

> [A]ll advertisements contain some information, and if a modicum of informative content were enough to supply the important contribution necessary to achieve tax exemption for commercial advertising, it would be the rare advertisement indeed that would fail to meet the test. Yet the statutory and regulatory scheme, even if not creating a *per se* rule *against* tax exemption, is clearly antagonistic to the concept of a *per se* rule *for* exemption . . . . Thus, the Claims Court properly directed its attention to the College's conduct of its advertising business, and it found the following pertinent facts:
>
> > The evidence is clear that plaintiff did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspect of the goods or services publicized. Those companies willing to pay for advertising space got it; others did not. Moreover, some of the advertising was for established drugs or devices and was repeated from one month to another, undermining the suggestion that the advertising was principally designed to alert readers of recent developments . . . . Some ads even concerned matters that had no conceivable relationship to the College's tax-exempt purposes.
>
> . . . This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the

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Revenue Service was considering whether clarification was needed as to the application of the "regularly carried on" requirement to business activities conducted on the Internet).

82 *Id.* § 1.513-4(f), example 7.

83 *Id.* at example 8. Where a document can be broken down into segments identified in the Treasury Regulations, a court or the Internal Revenue Service will likely analyze each segment with reference to the rules set out above. *See, e.g.*, Tech. Adv. Mem. 9805001 (Oct. 7, 1997) (concluding that an "ad" did not rise to the level of advertising when it consisted of a can of a sponsor's pet food made to look like a trophy and included two slogans that had long been used by the sponsor in its advertising).

84 *See, e.g.*, State Police Ass'n of Mass. v. Comm'r, 125 F.3d 1, 6 (1st Cir. 1997).

85 475 U.S. 834 (1986).

86 *Id.* at 847.

pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury.[87]

D. Payments Between Controlled Groups. When a charitable organization receives a "specified payment" from another entity which it controls, the payment is treated as unrelated business income to the extent the payment reduces the trade or business income of the controlled entity.[88] The term "specified payment" means any interest, annuity, royalty, or rent paid to the controlling organization.[89] For purposes of this rule, the term control means (1) in the case of a corporation, ownership (by vote or value) of more than 50% of the stock in a corporation,[90] or (2) in the case of a partnership, ownership of more than 50% of the profits interest or capital interest in a partnership.[91] In determining control, the constructive ownership rules of Code section 318 apply.[92] If a partnership owns stock in a corporation, ownership of the corporation will be attributed to the partners in the same proportion in which the partners hold their interests in the partnership.[93] In addition, if a shareholder owns 50% or more of the value of the stock in a corporation, stock in another entity owned by the corporation is considered as owned by its shareholder in proportion to the shareholder's ownership interest in the corporation.[94]

Code Section 318 is silent with respect to applying attribution rules among tax exempt organizations. On its face, Code Section 318 does not seem to attribute ownership in an entity from one nonstock tax exempt organization to another because the attribution rules focus on one's ownership interest in an organization. Ownership is not an appropriate criterion for tax exempt organizations because no one has an ownership interest in a nonstock tax exempt organization. For example, if two tax exempt organizations, which have identical boards of directors, each own

[87] *Id.* at 848–50 (citation omitted). Several cases and rulings follow the reasoning of *American College of Physicians*. *See, e.g.*, Minn. Holstein-Frisian Breeders Ass'n v. Comm'r, 64 T.C.M. (CCH) 1319 (1992) (holding that advertisements that may have been of "incidental benefit to breeders in running their day-to-day operations" but that did not "contribute importantly to improving the quality of the breed of Holstein-Friesian cattle" were not substantially related to a cattle breeding organization's exempt purposes); Fla. Trucking Ass'n v. Comm'r, 87 T.C. 1039 (1986) (holding that advertisements of products of particular interest to the trucking industry did not bear a substantial relationship to the exempt functions of a trucking trade association); Rev. Rul. 82-139, 1982-2 C.B. 108 (concluding that a bar association's publication of advertisements for products and services used by the legal profession was not substantially related to the association's exempt purposes).

[88] I.R.C. § 512(b)(13)(A). A modification to this rule applies to "qualifying specified payments" (i.e., specified payments made pursuant to a binding written contract in effect on Aug. 17, 2006) received or accrued after Dec. 31, 2005 and before Jan. 1, 2014. Under the modified rule, only the excess payments – the portion of the "qualifying specified payment" received or accrued by the controlling organization that exceeds the amount which would have been paid or accrued if such payment met the requirements prescribed under Code section 482 – is included in the controlling organization's UBTI, and only to the extent such excess payment reduces the trade or business income of the controlled entity. I.R.C. § 512(b)(13)(E).

[89] I.R.C. § 512(b)(13)(C).

[90] I.R.C. § 512(b)(13)(D)(i)(I).

[91] I.R.C. § 512(b)(13)(D)(i)(II).

[92] I.R.C. § 512(b)(13)(D)(ii).

[93] I.R.C. § 318(a)(2)(A).

[94] I.R.C. § 318(a)(2)(C).

a 50% interest in a for-profit corporation, the constructive ownership rules of Code Section 318 would not seem to attribute the ownership of the corporation's stock from one of the tax exempt organizations to the other.[95] Thus, since both tax exempt entities would own only 50% of the corporation's stock, the corporation would not be controlled by either tax exempt organization.[96] As a result, interest paid from the for-profit corporation to the tax exempt shareholders would not be considered unrelated business income.

However, by analogizing the principles of former Code Section 512(b)(13), ownership in an entity by one tax-exempt organization may be attributed to another tax-exempt organization if there is a common degree of management between the two tax-exempt organizations.[97] Former Code Section 512(b)(13) defined control by reference to Code Section 368(c) which provides that ownership of at least 80% of the corporation's stock effectuated control.[98] In applying the principles of Section 368(c), Treasury Regulation Section 1.512(b)-1(l)(4)(i)(b) states that in the context of nonstock tax-exempt organizations, control exists between two or more tax-exempt organizations in which more than 50% of the governing boards overlap.[99]

E. Unrelated Debt Financed Income. Property acquired by an exempt organization with borrowed funds may be considered debt-financed property.[100] Debt-financed property is property held by a charitable organization to produce income that is encumbered by acquisition indebtedness at any time during the taxable year.[101] The term "acquisition indebtedness" refers to acquisition or indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of acquisition.[102] There are several exceptions to the term acquisition indebtedness, including exceptions for property acquired by gift, bequest, or devise, indebtedness incurred in performing the organization's exempt function, and certain real property acquired by educational organizations, qualified plans, and multiple-parent title holding organizations.[103] Exceptions under which property acquired with financing escapes classification as debt-financed property include property used by an organization in performing its exempt function, property used in an unrelated trade or business, and property acquired for prospective exempt use.[104]

A certain portion of income derived from debt-financed property must be included in unrelated business taxable income as an item of gross income derived from an unrelated trade or business.[105] Similarly, a certain portion of the deductions directly connected with debt-financed

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95 Robert A. Wexler & Lisa R. Appleberry, *TRA '97 Brings Charities a Little Relief . . . and Maybe a Lot of Grief*, 87 J. TAX'N 360, 363 (1997).

96 *See* I.R.C. § 512(b)(13)(D).

97 *See* Wexler & Appleberry, *supra* note 83 at 363; *see also* Priv. Ltr. Rul. 199941048 (Oct. 18, 1999).

98 Former I.R.C. § 512(b)(13) (repealed by P.L. 105-34 § 1041(a)) (effective for tax years beginning before August 6, 1997).

99 Wexler & Appleberry, *supra* note 83 at 363.
100 I.R.C. § 514(b).
101 I.R.C. § 514(b)(1).
102 I.R.C. § 514(c)(1).
103 I.R.C. § 514(c).
104 I.R.C. § 514(b)(1), (3).
105 I.R.C. § 514(a)(1).

property are allowed as deductions in computing unrelated business taxable income.[106] The portion of income and deduction that must be taken into account is determined by applying a debt/basis percentage, which is equal to the ratio of the average acquisition indebtedness for the taxable year with respect to the property over the average amount of the adjusted basis of the property during the period it is held by the organization during the taxable year.[107]

The treatment of income and deductions from debt-financed property described above overrides the modifications from unrelated business taxable income otherwise provided for dividends, interest, payments with respect to securities loans, annuities, loan commitment fees, royalties, rents, and gains and losses from the sale, exchange, or other disposition of property.[108] In other words, the amount ascertained under the debt-financed property rules is expressly required to be included as an item of gross income derived from an unrelated trade or business despite the fact that the source of such income is passive in nature.

IV. Special Concerns.

A. <u>Partnerships</u>. Section 702(b) of the Code provides that the character in the hands of a partner of an item of partnership income is determined as if the item were realized directed from the source from which realized by the partnership. For example, if an entity's share of partnership income is derived from debt-financed property, the income from the property is generally taxable as debt-financed income.[109]

Technical Advice Memorandum 9651001 indicates that the use of multiple pass-through entities does not change this result.[110] There, an exempt organization ("X") held an interest in a limited partnership ("Z"). Z in turn owned an interest in a joint venture ("Venture"). Venture owned property that was collateral for a mortgage note. X eventually sold its interest in Z. The issue in the Technical Advice Memorandum was whether this sale was subject to unrelated business income tax under Section 511 of the Code because Z owned debt-financed property. The IRS concluded that it was, explaining, "[a]n interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result in another." Under this reasoning, the same result follows if the income in question was derived from debt-financed property other than through a sale of the exempt entity's interest in a pass-through entity. Regardless of how many layers of pass-through entities are imposed, the "lowest level" entity's property would effectively be owned by each entity up the line, and would ultimately effectively be owned by the tax exempt entity.

To avoid the realization of debt-financed income through an investment in a limited partnership or hedge fund, charitable organizations often use "blocker" entities to acquire these investments. A "blocker" entity is a corporate entity that is interposed between the investment

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106 I.R.C. § 514(a)(2).
107 I.R.C. § 514(a)(1).
108 I.R.C. § 512(b)(4).
109 *See, e.g.*, Rev. Rul. 74-197, 1974-1 C.B. 143. Example 4 in Treasury Regulation Section 1.514(c)-1(a)(2) specifically demonstrates that this is so. Treas. Reg. § 1.514(c)-1(a)(2), example 4. Relying upon Section 702(b), Example 4 explains that if an entity ("X") is a limited partner in a partnership that borrows money to purchase an office building for lease to the general public, X's share of the income from the building is debt-financed income. *Id.*
110 Tech. Adv. Mem. 9651001 (Dec. 20, 1996).

and the charitable organization. The corporation "blocks" the attribution of any debt in the investment partnership to the charitable organization, and thus enables the charitable organization to avoid the application of the debt-financed income rules with respect to the investment income generated by the investment partnership. Rather, the partnership income is taxed to the corporate blocker entity. Often, the blocker entity is a foreign corporation formed in a low tax jurisdiction. As a result, the blocker entity pays little or no tax on the income from the investment partnership or hedge fund. The blocker entity in turn distributes the income received from the investment partnership to the charitable organization in the form of dividends, which is excluded from the charitable organization's unrelated business taxable income.[111] The IRS has issued a private letter ruling determining that dividends received by a charitable organization from a foreign corporation used as a blocker entity is not subject to the unrelated business income tax.[112] Although the use of blocker entities may appear to be a "loophole," blocker entities are often used to avoid the application of the unrelated debt-financed income rules to passive investments that were never intended to be within the scope of the rules.

B. <u>S Corporations</u>. Charities are able to hold S corporation shares without breaking the S election.[113] However, all income distributable to a charitable S corporation shareholder will be treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business.[114] Consequently, "(i) all items of income, loss, or deduction taken into account under Section 1366(a), and (ii) any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization."[115] In addition, the basis of any S corporation stock acquired by purchase is reduced by the amount of dividends received by the charitable organization with respect to the stock.[116]

C. <u>Public Disclosure of Information Relating to the Unrelated Business Income Tax</u>. Charitable organizations are required to make their annual Form 990/Form 990PF information returns and exemption materials available for public inspection.[117] Organizations that have unrelated business income also have to file a Form 990-T return. Charitable organizations described in Section 501(c)(3)[118] are required to make their Form 990-T returns[119] available for public inspection.[120] Certain information may be withheld by the charitable organization from public disclosure and inspection (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the charitable organization) *if* the Secretary determines that public disclosure of such information would adversely affect the charitable organization.[121] Under the

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[111] *See* I.R.C. § 512(b)(1).
[112] Priv. Ltr. Rul. 199952086 (Sept. 30, 1999).
[113] *See* I.R.C. § 1361(c)(6).
[114] I.R.C. § 512(e).
[115] *Id*.
[116] I.R.C. § 512(e)(2).
[117] I.R.C. § 6104(d)(1)(A).
[118] This requirement applies to all charitable organizations which file Form 990-T returns, regardless of whether such organizations are also required to file annual Form 990/Form 990PF information returns. However, state colleges and universities which are exempt from income tax solely under Section 115 of the Code are not required to make their Form 990-T returns available for public inspection. Notice 2007-45, 2007-22 I.R.B. 1320.
[119] An exact copy of the Form 990-T return, including all schedules, attachments and supporting documents must be disclosed. Notice 2007-45, 2007-22 I.R.B. 1320.
[120] I.R.C. § 6104(d)(1)(A)(ii).
[121] Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 330.

commensurate in scope test, an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources.[122] However, if a substantial portion of the charity's income is from unrelated activities, the organization fails to qualify for exemption.[123]

D. Effect of Unrelated Business Activities on the Charity's Tax-Exempt Status. In order to obtain and maintain tax-exempt status, a charity must be operated primarily for the purposes described in Section 501(c)(3) of the Code. Accordingly, if a charity engages in too much unrelated business activity, it risks the loss of its tax-exempt status as no longer satisfying this operational test. There is no bright line rule with respect to how much unrelated business income a charity may receive without jeopardizing its tax-exempt status.[124] Whether an organization has a substantial non-exempt purpose is a question of fact.[125]

The IRS uses two alternate tests to determine whether an exempt organization's unrelated business activity jeopardizes its exempt status: the commensurate in scope test and the primary purpose test. Under the commensurate in scope test an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources.[126] The determination hinges on whether the effort expended by the charitable organization to carry out its exempt functions is commensurate in scope with the organization's financial resources.[127] Under the primary purpose test, if a substantial portion of an exempt organization's income is from unrelated business activities, the organization fails to qualify for exemption.[128]

E. Use of Taxable Subsidiaries. If a charity engages in an activity that may produce substantial unrelated business income, the charity should consider conducting the activity through a taxable corporate subsidiary wholly owned by the charity. The taxable subsidiary will be responsible for paying income tax on the net taxable income from the activity. The net income may then be distributed to the charity in the form of dividends which generally are excluded from a charity's UBTI.

One advantage of this structure is that the activities of the taxable subsidiary normally will not be attributed to the charity. This is especially important if the conduct of the activity is so substantial that it may jeopardize the charity's tax-exemption. Second, the charity will not be required to file a Form 990-T related to the activity, which is available for public inspection. Although the taxable subsidiary will file a Form 1120, such form is not required to be made publicly available. Third, use of a taxable subsidiary can protect the charity's assets from liabilities arising from the conduct of the unrelated business activity and isolate those liabilities to

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[122] Rev. Rul. 64-182, 1964-1 C.B. 186.
[123] Treas. Reg. § 1.501(c)(3)-1(c)(1).
[124] In making this determination, courts may examine the amount of time or money spent on carrying out an unrelated trade or business. *See* Orange County Agricultural Society v. Comm'r, 893 F.2d 529 (2d Cir. 1990), *aff'g* 55 T.C.M. 1602 (1988) (denying exempt status where an organization received approximately one-third of its gross income from unrelated business activities).
[125] *See* Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945) (holding that the presence of a single, non-exempt purpose, if substantial in nature, will destroy exemption regardless of the number of importance of truly exempt purposes); B.S.W. Group v. Commissioner, 70 T.C. 352 (1978); Nationalist Movement v. Comm'r, 102 T.C. 558, 559 (1994), *aff'd*, 37 F.3d 216 (5th Cir. 1994).
[126] Rev. Rul. 64-182, 1964-1 C.B. 186.
[127] *Id.*
[128] Treas. Reg. § 1.501(c)(3)-1(c)(1).

the taxable subsidiary. Fourth, a taxable subsidiary has greater ease in claiming tax deductions under section 162 (ordinary and necessary business expense) versus under section 512(a)(1) (directly connected with unrelated trade or business expense).[129] Finally, a taxable subsidiary can provide greater flexibility in structuring the unrelated business activity.

However, use of a taxable subsidiary may increase administrative burdens and costs of the charity. Additionally, the dividends from the taxable subsidiary may no longer be exempt from UBIT if the charity transfers debt-financed property to the taxable subsidiary.[130] If the charity provides administrative services to its taxable subsidiary for a fee, the IRS may reallocate income between the charity and the taxable subsidiary under Code section 482. Finally, as discussed above, if the charity receives interest, rent, annuity payments or royalties from its controlled taxable subsidiary, such payment may be treated as unrelated business income to the charity to the extent the payment reduces the trade or business income of the taxable subsidiary.[131]

[129] Exempt organizations may only offset UBTI with directly connected expenses. A "directly connected" expense is one which has a proximate and primary relationship to the carrying on of the trade or business. Treas. Reg. § 1.512(a)-1(a).
[130] I.R.C. § 357(c); Rev. Rul. 77-71, 1977-1 C.B. 155.

[131] I.R.C. § 512(b)(13).

What Every Tax Lawyer Needs to Know About ERISA

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State Bar of Texas
Tax Law in a Day
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I. SCOPE OF THE ARTICLE

Almost all companies, other than very small employers, offer some form of employee benefits to their workforce. As a tax practitioner, even if you are not advising the client regarding employee benefits matters, it is important to understand some of the laws governing benefit plans work, and how these laws may impact other aspects of a client's business.

There are many different laws that may impact these plans, including the Internal Revenue Code of 1986, as amended, the Family Medical Leave Act, and the Age Discrimination in Employment Act. However, the one law that applies to most plans provided by employers and is often found to be the most confusing for employers, is the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. §§ 1001 *et seq.* (the "Act"). This paper provides a brief overview of Title I, Parts 1 through 5 of the Act, but does not provide an in-depth review of those areas, and does not discuss Parts 6 or 7 of Title I, Title II, Title III or Title IV of the Act due to the incredible breadth of those areas. Instead, this paper focuses on some of the basic terminology required in order to understand the Act, the reporting and disclosure obligations under the Act, and the general fiduciary duties which impact many individuals dealing with plans covered by the Act.

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II. HISTORY OF ERISA

Prior to the enactment of the Act in 1974, generally the only regulation of benefit plans was through the federal income tax laws, which provided tax incentives for employers to provide certain "qualified" retirement plans, and other more limited legislation enacted by Congress, such as the Welfare and Pension Disclosure Act of 1958, intended to protect the financial integrity of pension plans. None of these laws provided a detailed infrastructure for the operation and compliance obligations of employee plans, and none of these laws mandated funding levels or protected the benefits of participants in the plans. However, the closing of the Studebaker-Packard Corporation ("Studebaker") automobile plant in 1963 raised alarm in lawmakers regarding the need to protect participants in retirement plans from employer actions. Following the plant closing, Studebaker terminated its retirement plan for hourly workers and the plan was unable to meet its obligations. This failure to meet benefit obligations spurred the United Auto Workers to urge lawmakers to enact legislation addressing default risk and termination insurance for pension plans.[1]

However, as can happen with any legislation, the Act was stalled in committee for several years. In the midst of the Watergate scandal, and on the heels of the Vietnam War, Congress wanted to enact legislation that was pro-employee, and the Act was the only legislation that was close enough to completion to be enacted. While the Act was close to completion, the one issue that Congress had not resolved was what federal agency should be given the authority to enforce the Act, the U.S. Department of Labor or the U.S. Department of Treasury. In their haste to push the Act through, this dilemma was never solved, and instead, Congress enacted the Act in 1974 with both agencies given enforcement authority over the Act. This split in authority resulted in duplicative provisions in the Labor Code and the Internal Revenue Code, and a risk for employers that they will face enforcement actions from two different agencies for the same violation of the Act.

Since its enactment, Congress has made numerous amendments to the Act, each time trying to better achieve the original purposes of the Act to address employee benefits security, standards of plan administration, eligibility and vesting standards, adequate funding for plan benefits, fiduciary standards, disclosure of plan benefit information, and enforceability of participant rights. However, with each amendment, the complexity of the Act has increased, making it even more important for practitioners to understand the basics of the Act in order to assist plan sponsors with compliance.

III. STRUCTURE OF THE ACT

The Act is organized into four titles and the first title is divided into seven Parts, with each title and part addressing the core purposes of the Act. Part 1 addresses reporting (to the government agencies with jurisdiction over employee benefit plans) and disclosure (to the persons participating in the plans and their beneficiaries). Part 2 addresses participation and vesting standards for retirement plans (designed to protect employees to ensure that the retirement plans cover eligible persons when required and that the participants then earn vested rights to the benefits under the plan). Part 3 provides the funding requirements (for retirement plans and particularly for defined benefit plans). Parts 2 and 3 also are included in the Internal Revenue Code of 1986, as amended (the "Code").

Part 4 addresses the fiduciary requirements, including the provisions for participant directed accounts, the prohibition on engaging in prohibited transactions and the statute of limitation for bringing actions based upon a breach of fiduciary duty. Part 5 provides the administration and enforcement mechanism, including the provisions allowing the U.S. Department of Labor to enforce a participant's rights and to enforce the legal requirements of the Act, and the procedures by which participants and beneficiaries can make claims for benefits and appeal denials of benefits. Part 6 includes the requirements for health plans to offer certain employees the right to continue coverage under the health plan after it would otherwise cease for limited periods (also know as COBRA continuation coverage). Part 7 includes the requirements that a health plan may not discriminate against a person based upon their health status (also known as "HIPAA").

Title II of the Act deals with the jurisdiction of the federal agencies enforcing the Act and certain procedural issues. Title III of the Act contains the provisions for terminating defined benefit pension plans and the establishment of the Pension Benefit Guaranty Corporation ("PBGC") that insures some of the benefits of defined benefit plans when the employers relinquish the defined benefit plans in bankruptcy or upon dissolution of the employer.

IV. THE TERMINOLOGY NEEDED TO NAVIGATE THE ACT

As mentioned previously, the Act generally applies to employee benefit plans. An "employee benefit plan" is an "employee welfare benefit plan" or an "employee pension benefit plan" or a plan that is both types of plans.[2] However, there are some exceptions to what types of plans are covered by the Act. For example, the Act generally does not cover governmental plans, church plans not electing to be covered, plans designed to meet applicable workers' compensation, unemployment or disability insurance laws, plans maintained outside the U.S. primarily for nonresident aliens, or unfunded excess benefit plans.[3] In addition, the Department of Labor has ruled that certain unfunded employee educational assistance programs are not covered under the Act.[4]

The Act also does not apply to plans that do not cover employees.[5] A plan does not cover "employees" if its only participants are (a) an individual and/or his/her spouse who are the sole owner(s) of the business sponsoring the plan, or (b) partners and their spouses.[6] Similarly, it has been held that no "plan" is created when an employer makes health insurance available to employees to buy at their cost, but does nothing more respecting the program.[7] This rule has been narrowly applied and employers must use care to ensure that they do not take any actions that endorse or promote the program.[8] Finally, it is important to note that just because a plan is not in writing does not mean that it is not subject to the Act.

A. Employee Welfare Benefit Plan

The Act defines an employee welfare benefit plan as:

> Any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event that sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 302(c) of the Labor Management Relations Act, 1947 (other than pensions on retirement or death, and insurance to provide such pensions).[9]

The most common types of "employee welfare benefit plans" established by businesses are medical, dental and vision plans. These plans can be funded solely by insurance (commonly referred to as a "fully-insured plan"), funded solely from the sponsoring general assets (commonly referred to as a "self-funded plan"), or a combination of both.

Although this definition is extremely broad, the regulations issued under Section 3 of the Act provide for exceptions from this definition. Specifically, 29 C.F.R. § 2510.3-1(b) provides that an "employee welfare benefit plan" does not include any of the following types of plans, programs, or policies:

1. Policies regarding overtime pay, shift premiums, holiday premiums, or weekend premiums;

2. Policies that pay an employee's normal compensation, out of the employer's general assets, on account of periods of time during which the employee is physically or mentally unable to perform his or her duties, or otherwise is absent for medical reasons (such as pregnancy, a physical examination or psychiatric treatment); and

3. Policies regarding vacation pay, pay during a military leave of absence, pay during a leave of absence for jury duty, pay during training, and pay during a sabbatical leave or education leave.[10]

These exceptions are generally referred to as "payroll practices." Unfunded sick pay, vacation pay, holiday pay, military leave pay, jury duty, training pay or educational leave pay or scholarship plans or programs are not covered by the Act[11] nor are on-premises recreation, dining or first-aid facilities, in-service bonuses or holiday gifts, remembrances, employee discounts, hiring halls, strike funds, and 100% voluntary, employee-paid insurance programs that are not sponsored or endorsed by the employer.[12]

One common area of confusion is regarding whether disability plans are covered by the Act. If a disability plan is fully-insured, it will be an employee welfare benefit plan, subject to the Act.[13] However, a disability program that is paid entirely out of the employer's general assets would fall within the second exception under 29 C.F.R. § 2510.3-1(b) and thus, would be deemed a "payroll practice." According to the Department of Labor, a disability plan falls into the category of a payroll practice if it is designed to replace the loss of an employee's normal compensation for absences from work resulting from medical problems that are foreseeable temporarily.[14] For example, the Department of Labor found that a short-term disability policy constituted a payroll practice because payments were made from the employer's general assets, were no greater than the employee's compensation, and were due to illness or injury resulting in the employee's absence from duty.[15] Both the Department of Labor and the courts have held that a short-term disability plan is not subject to the Act merely because the plan does not provide for payment of 100% of the employee's compensation while on leave. The Department of Labor has issued several opinion letters in which it has found that plans that provide less than an employee's normal compensation are payroll practices.[16] The Department of Labor's position is that providing benefits equivalent to an employee's normal compensation is not a minimum requirement for the exemption, but a maximum cap. The payment of less than normal compensation from an employer's general assets therefore, can constitute an employer payroll practice exempt from the Act.[17] However, it is important to note that the fact that a disability plan funds payments from its general assets does not alone exempt the plan from the Act's coverage.[18]

An employer cannot elect to treat a disability plan as subject to the Act if the plan would otherwise be exempt. However, if the plan document is designed to provide that the participants and beneficiaries have rights under the Act and if the company complies with the Act by filing an annual Form 5500 relating to the plan, a court may not question whether the plan is subject to the Act. For example, in *Stoltz v. Fenn Manufacturing Co.*, the employer sponsored a self-funded short term disability plan that paid eligible participants normal compensation when the participant was absent for work due to a disability.[19] In analyzing a participant's claim for benefits, the U.S. District Court simply stated that the employer has a self-funded ERISA regulated short term disability plan that provides up to twenty-six weeks of benefits to employees while they are disabled."[20]

Another area of confusion is regarding whether severance pay policies or programs are covered by the Act. Many employers have only informal severance pay policies or arrangements, and commonly assume that these policies and arrangements are not subject to the Act. Although informal arrangements typically feature one-time payments in response to ad hoc situations, it is not always clear when they become "employee benefit plans" that are subject to the Act, and employers should not assume that they are automatically exempt from the Act's requirements.

Whether a severance arrangement is informal and not subject to the Act will depend on the individual circumstances surrounding the arrangement and its communication to affected employees. In determining whether a severance arrangement is or is not subject to the Act, courts determine whether there is some type of "ongoing administrative scheme." A growing number of cases have grappled with the extent of ongoing administration and the amount of employer involvement needed to create a plan. In *Fort Halifax Packing Co. v. Coyne*,[21] the Supreme Court held that a state law requiring an employer to make a single severance payment upon a plant closing was not preempted because it did not require the employer to maintain an ongoing administrative scheme and, thus, did not require the creation of a plan subject to the Act. Most of the lower courts have accorded a narrow reading to *Fort Halifax*.[22] In *Belanger v. Wyman-Gordon Co*.,[23] the First Circuit held that an employer did not create a "plan" where it offered four separate lump-sum severance pay early retirement programs in a four-year period, where the employer devised each offer without considering possible future offers, each offer was motivated by specific needs, and each involved only a one-time, lump-sum payment. The court said that the employer did not, by these offers, assume an ongoing administrative or financial commitment.

It is generally not to the employer's advantage to have its severance strategy characterized as an informal arrangement not subject to the Act. For example, the beneficiary of such an arrangement is able to sue in state court for benefits. This could expose the employer to larger damage awards than are available under the Act.

If a severance plan is subject to the Act, it is typically classified as an "employee welfare benefit plan." However, if severance benefits are contingent (directly or indirectly) on retirement, exceed double the employee's final annual compensation, or are not completed within 24 months of termination from service (or, if later, within 24 months after normal retirement age if the termination was " in connection with a limited program of terminations"), the arrangement will be viewed as a pension plan.[24] Severance pay eligibility standards that require attainment of a specific age and/or substantial service and in practice limit benefits to senior employees indicate the plan is a retirement rather than a severance pay plan.[25]

B. Employee Pension Benefit Plan

The Act defines an "employee pension benefit plan" as:

> Any plan, fund, or program, which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program –
>
> (i) provides retirement income to employees, or
>
> (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,
>
> regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan. A distribution from a plan, fund, or program shall not be treated as made in a form other than retirement income or as a distribution prior to termination of covered employment solely because such distribution is made to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.[26]

There are generally two forms of employee pension benefit plans: (i) defined benefit plans and (ii) individual account plans (generally referred to as defined contribution plans). The primary difference between the two types of plans is that in the individual account plan, the plan must provide for an individual account for each participant and the benefits in the plan will be based solely upon the amount of contributions made to the account (and investment gains and losses on those contributions).[27] An example of an individual account plan is a 401(k) plan. A defined benefit plan is generally any pension plan that is not an individual account plan.[28]

C. Plan Sponsor

When discussing employee benefit plans, practitioners often refer to the "plan sponsor." The Act defines the "plan sponsor" as:

> (i) the employer in the case of an employee benefit plan established or maintained by a single employer, (ii) the employee organization in the case of a plan established or maintained by an employee organization, or (iii) in the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.[29]

D. Administrator

One area of confusion among plan sponsors is who constitutes the "administrator" of the plan. Most employers, when asked who the plan administrator is for their plan, will respond that it is a third party with whom the company has contracted for plan administration. However, that entity is really the third party administrator, and not the administrator for purposes of the Act. The Act specifically defines the "administrator" as:

> (i) the person specifically so designated by the terms of the instrument under which the plan is operated;
>
> (ii) if an administrator is not so designated, the plan sponsor; or
>
> (iii) in the case of a plan for which an administrator is not designated and a plan sponsor cannot be identified, such other person as the Secretary may by regulations prescribe.[30]

Most plan documents specify that the company sponsoring the plan is the administrator, in which case, the corporate body, typically the board of directors of the company, will be treated as the plan administrator. If the entire board of directors is the plan administrator, then the entire board of directors will be treated as fiduciaries for purposes of the plan (see the discussion below of fiduciary duties and liability under Part 4 of the Act). Many companies choose to appoint a smaller committee of the board of directors to be named as the plan administrator in order to reduce the number of individuals on the board who are treated as fiduciaries and to enable faster action in addressing the needs of the plan.

E. Employer

For purposes of the Act, an "employer" is any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity.[31] If an organization is comprised of one or more corporations or other business entities under common ownership, those corporations and other business entities may be treated as one "employer" for purposes of the Act, including attaching liability for underfunded defined benefit plans under Title IV of the Act, depending upon the level of common ownership between the entities. Generally, one "employer" will include those organizations that are either (i) members of a controlled group for purposes of Code Section 414(b), or (ii) groups under common control for purposes of Code Section 414(c), must be combined and treated as a single employer. Code Section 414(b) provides that employees of all corporations which are members of a controlled group of corporations as defined in Code Section 1563(a) shall be treated as employed by a single employer. Generally, Code Section 414(b) is limited to controlled groups consisting of only corporations. However, Code Section 414(c) applies to all other controlled groups involving entities other than corporations, and the ownership tests under this provision take into consideration ownership of an actuarial interest in a trust or estate, and ownership of a profits or capital interests for other entities. A group of businesses under common control, as described in Code Section 414(c), can include corporations, partnerships, limited liability companies, sole proprietorships, tax-exempt organizations or any other business forms.

The term "controlled group of businesses" includes three general categories of affiliation:

(i) Parent-subsidiary groups, consisting of one or more chains of organizations connected with a common parent organization through at least an 80% ownership interest in the capital or profits of the organizations;

(ii) Brother-sister groups, consisting of two or more organizations if five or fewer individuals, estates and/or trusts satisfy an 80% common ownership test, and a 50% identical ownership test, taking each person's ownership into account only to the extent of the individual's smallest proportionate interest in any of the corporations; and

(iii) Combined groups, consisting of three or more organizations, at least one of which is both parent of a parent-subsidiary group, and a member of a brother-sister group and each of which is a member of either a parent-subsidiary group or a brother-sister group.

F. Top Hat Plans

While the term "top hat plan" is not specifically defined in the Act, it is important to understand the term, which is commonly used by practitioners, and to understand what portions of the Act apply to these types of plans. Sections 201, 301, and 401 of the Act provide that the vesting, participation, funding, and fiduciary responsibility provisions of the Act do not apply to any unfunded plan that an employer maintains primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees, also commonly referred to as a "top hat" plan.[32] Neither the statutes nor regulations define what constitutes a "select group of management or highly compensated employees" for purposes of the "top hat" plan exemption. The determination is based on the facts and circumstances of the individual plan. According to the Department of Labor, a nonqualified deferred compensation plan will only be considered a "top hat" plan if all of the eligible employees are part of either a select group of highly compensated employees or a select group of management.[33]

In 2001 in *Carrabba v. Randall's Food Markets*, the Fifth Circuit Court of Appeals affirmed a district court decision that a deferred compensation plan, that the employer intended to be a top hat plan, did not qualify as a top hat plan because it failed to benefit a select group of either the broader group of all management or all highly compensated employees.[34] In *Carrabba*, the plan defined eligible employees as a limited group of employees, first defining the group of eligible employees as all salaried employees and later limiting the group to specific positions and salary levels within the company.[35] After reviewing the various definitions of eligible employees and the facts surrounding the management and compensation levels of the participants in the plan, the court held that it was unable to find that the plan was maintained by the company "primarily . . . for a select group of management or highly compensated employees."[36] In holding that the plan did not benefit a select group of employees, the court focused on the fact that it found no evidence that any significant number of the participants in the plan had such influence by virtue of their positions with the company that they could individually protect their retirement and deferred compensation expectations by direct negotiations with the company.[37]

Courts in other jurisdictions have used less strict standards in determining whether a plan benefits a select group of management or highly compensated employees.[38] Most recently, a Massachusetts district court (1st Circuit) used *Demery*[39] and other cases to explain what constitutes a select group of management or highly compensated employees.[40] The first step is to determine whether the plan covers a select group. A review of cases leads to the conclusion that 15% of employees is probably at or near the upper limit of the acceptable size for a "select group."[41] The court stated that if participation in the plan is optional, then the percentage of employees includes everyone who was invited to contribute to the plan; if participation is mandatory, the percentage only includes those who actually contribute. In this case, two unfunded deferred compensation plans were established to which surgeons' compensation was automatically contributed to the extent such compensation exceeded a salary cap. The court based the percentage participation not on the percentage of employees who were surgeons and could theoretically contribute if their salaries were high enough, but rather on the percentage of employees who actually contributed. The court reasoned that, as a practical matter, the plans were "maintained" only for those highest earning surgeons.[42] The second step is to determine if the select group is made up of "management or highly compensated employees." "Highly compensated" is established both in absolute terms (the participants earn a large salary) and in relative terms (the participants earn multiple times the amount of the average employees).[43] "Management" level is sufficient for top hat plans; "executive" level seniority is not required.[44] A plan may benefit highly compensated or management employees; the select group can, but need not, be both.[45]

V. TITLE I

A. Part 1 – Reporting and Disclosure

Part 1 of Title I sets forth the various reporting and disclosure obligations of plan sponsors with respect to employee benefit plans. Specifically, Part 1 requires plans sponsors to provide the following information to participants and beneficiaries of the plan:

- A summary plan description to each participant and beneficiary within 90 days of the date the individual becomes a participant in the plan, and generally every five years thereafter.[46]
- A summary of material modifications to each participant and beneficiary within 210 days after the end of the year in which an amendment to the plan is adopted (except if the amendment is a material reduction in health plan benefits or covered services, in which case, the summary of material modifications must be provided no later than 60 days after the date of the modification or change).[47]
- A statement of benefits for defined benefit plans every three years or an annual notice; for defined contribution plans, annually, or quarterly if the plan provides for participant-directed investments.
- A summary annual report for defined contribution plans nine months after the end of each plan year.[48]
- An annual funding notice for defined benefit plans 120 days after the end of each plan year (discussed in more detail below).[49]
- A blackout notice for any individual account plans (i.e., defined contribution plans and certain money purchase pension plans) that will have a period of three or more business days where participants and beneficiaries will have limited access to their accounts.[50]

In addition to the disclosures to participants and beneficiaries, the Act requires most plan sponsors to files an annual report on Form 5500 by the last day of the seventh month after the end of each plan year (or, the plan sponsor timely files a Form 5558. There are two exceptions to this requirement (i) certain employee welfare benefit plans with less than 100 participants as of the first day of the plan year to which the filing relates (discussed in further detail below) and (ii) top-hat plans after the plan files a special one time filing within 120 days of the establishment of the plan.

If a health plan meets all of the following requirements, then the plan administrator is exempted from certain disclosure obligations under the Act. The disclosure obligations the plan administrator may be exempted from include filing a summary plan description, summary of material modifications, or a terminal report with the Department of Labor and the plan administrator is not required to furnish upon written request of any participant or beneficiary a copy of the plan description or a terminal report and the employer need not make copies of the plan description available for examination by participants or beneficiaries in their principal office. Satisfying the requirements of this disclosure exemption is also one of the conditions a plan must satisfy to qualify for an exemption from the Form 5500 reporting requirements explained below. The plan must meet the following requirements to qualify for the disclosure exemptions:

- the welfare plan has less than 100 participants at the beginning of the plan year;
- the welfare benefit plan provides benefits to employees of two or more unaffiliated employers, provided the provision of the benefits is not in connection with a multiemployer plan;
- the employers fully insure one or more of the welfare plans of each of the participating employers with an insurance policy that is purchased by either the employer or the employers and the employees and the contributions by the employees are forwarded by the employer to the insurance company within three months of receipt;
- the refunds the employer receives are returned to the employees within three months of the date the employer receives the refunds;
- the contributing participants are informed when they enter the plan that any refund that is allocated to them will be returned to them within three months; and
- the plan uses a trust (or entity such as a trade association) as the holder of the insurance contract and the conduit for payment of premiums to the insurance company.[51]

An employee welfare benefit plan is exempt from filing the annual report on Form 5500 if it meets all of the above requirements and it satisfies all of the following requirements:

- the plan has fewer than 100 participants at the beginning of the plan year;
- an annual report is filed by the Trust or the entity holding the group insurance contract, and participants are given a summary annual report for the plan.[52] It is unclear what kind of a "trust" is intended by this regulation.

A second exemption exists to exempt employee welfare benefit plans from a portion of the reporting requirements, particularly the requirement that they be audited by an independent certified public accountant and file such audit report with the annual report. A welfare benefit plan is exempt from the audit report requirement under 29 C.F.R. § 2520.104-44 if:

- the benefits are paid solely from the general assets of the employer, or an insurance contract, or an HMO contract, or a combination of the general assets of the employer and an insurance contract or an HMO contract (Note: the Department of Labor does not consider amounts contributed by employees through a cafeteria plan to be employer contributions as the Internal Revenue Service does; thus, many employers who believe that they are paying benefits out of their general assets when they pay a portion of the benefits from employee contributions from a cafeteria plan are not in compliance with the Department of Labor's interpretation of this exemption);
- refunds of premiums are refunded to participants within three months of receipt; and
- contributions are forwarded to the insurance company or plans within three months of receipt.

Section 101(d) of the Act requires any employer that maintains a defined benefit plan (other than a multiemployer plan) to provide each participant and beneficiary with a written notice within 60 days following the due date for any required installment or other payment required to meet the minimum funding standard, if the employer fails to make the required payment.[53] This notice is not required if the employer has filed a waiver request under Section 303 of the Act with respect to the plan year to which the required installment relates, provided that if the waiver request is denied, then the notice must be provided within 60 days of the denial.[54]

Section 101(f) of the Act requires each administrator of a defined benefit plan each plan year to provide a plan funding notice to the PBGC, to each plan participant and beneficiary, to each labor organization representing such participants or beneficiaries, and in the case of a multiemployer plan, to each employer that has an obligation to contribute to the plan. In 2009, the Department of Labor issued a Field Assistance Bulletin (No. 2009-

01) ("FAB") addressing the annual funding notice required by Section 101(f) of the Act. The FAB contains a model form of notice that can be used to provide the notice. The FAB also relieves employers from furnishing the notice to the PBGC, pending further guidance, so long as the plan's liabilities do not exceed its assets by more than $50MM, provided the employer furnishes the notice if the PBGC so requests in writing.

Section 101(m) of the Act provides that "no later than 30 days before the first date on which an applicable individual of an applicable individual account plan is eligible to exercise the right under Section 204(j) of the Act to direct the proceeds from the divestment of employer securities with respect to any type of contribution, the administrator shall provide to such individual a notice:" (1) describing the right to direct the proceeds and (2) describing the importance of diversifying the investment of retirement account assets.[55]

B. Part 2 – Participant and Vesting

Part 2 of the Act establishes the minimum participation requirements and minimum vesting standards with which each plan subject to Part 2 must comply. The requirements of Title I, Part 2 apply to all employee benefit plans other than (i) employee welfare benefit plans; (ii) top hat plans; (iii) plans sponsored by certain types of tax exempt organizations; (iv) excess benefit plans; and (v) individual retirement accounts or annuities.[56]

Section 202 of the Act specifically prohibits employee pension plans from imposing eligibility restrictions for participation beyond the later of the date the individual attains age 21 or completes one year of service.[57] One exception to this prohibition is that the plan can require two years of service if participants become 100% vested after two years.[58] In addition, plans cannot exclude employees from participation in a plan once the employee attains a certain age (for example, the plan cannot state that participants cease accruing benefits after age 50).[59]

Section 203 of the Act provides that all benefits must become non-forfeitable upon the later of age 65 or five years of service (referred to as the "normal retirement age"), and that all plans must meet certain minimum vesting requirements.[60] Specifically, if the plan provides for "cliff" vesting (meaning that the benefits all vest at one time after a certain period of time), then the vesting schedule can be no longer than three years for defined contribution plans and five years for defined benefit plans.[61] If the plan provides for graded vesting (meaning that a portion of the benefit vests each year, for example, 20% per year over five years), then the benefit must be fully vesting within seven years for defined benefit plans, and within six years for defined contribution plans.[62]

In addition to the vesting requirements, plans cannot be amended to reduce accrued benefits, also referred to as "protected benefits". Generally, protected benefits include contributions to the extent that the service requirements for the contributions have been met, distribution options under the plan, and vesting schedules. With respect to defined contribution plans, the Act prohibits the cessation or reduction of contributions to accounts or the rate of contributions to the plan on account of the participant's age. With respect to defined benefit plans, the Act require plans to accrue benefits throughout the employee's career rather than "back-loading" (i.e., accruing benefits in the years closer to retirement).

Section 204 of the Act sets forth the benefit accrual requirements for employee pension benefit plans. With respect to defined benefit plans, Section 204(b)(1) provides that the plan will meet the Act's minimum accrual requirements if each participant in the plan is entitled to a benefit upon his or her separation from service that is not less than: "(i) 3 percent of the normal retirement benefit to which he would be entitled at the normal retirement age if he commenced participation at the earliest possible entry age under the plan and served continuously until the earlier of age 65 or the normal retirement age specified under the plan, multiplied by (ii) the number of years (not in excess of 33 1/3) of his participation in the plan."[63] A plan will be deemed to have satisfied the requirements of Section 204 of the Act with respect to a plan year if:

> . . . under the plan the accrued benefit payable at the normal retirement age is equal to the normal retirement benefit and the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later

> plan year is not more than 133 1/3 percent of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year and before such later plan year.[64]

A defined benefit plan also is deemed to meet the requirements of Section 204 of the Act if the accrued benefit to which any participant is entitled upon his separation from service:

> . . . is not less than a fraction of the annual benefit commencing at normal retirement age to which he would be entitled under the plan as in effect on the date of his separation if he continued to earn annually until normal retirement age the same rate of compensation upon which his normal retirement benefit would be computed under the plan, determined as if he had attained normal retirement age on the date any such determination is made (but taking into account no more than 10 years of service immediately preceding his separation from service).[65]

Participants are not the only parties protected by the provisions of Part 2 of Title I. Spouses also receive some protections, including the following:

- If the plan offers an annuity, that the normal form of benefits for a married participant is a qualified and joint 50% survivor annuity;[66]
- If the plan offers an annuity, the plan must offer a qualified preretirement survivor annuity (i.e., an annuity that is payable if the participant dies before annuity payments begin);[67]
- If the participant in a defined contribution plan is married, his or her spouse is automatically the participant's beneficiary unless the spouse has consented, in writing, to the naming of a different beneficiary;
- Each plan must adopt procedures for reviewing qualified domestic relation orders ("QDROs") and evaluate and determine whether any court orders received by the plan comply with the requirements under the Act for QDROs. QDROs constitute an exception to the general prohibition in the Act against assignment and alienation of plan benefits.[68]

C. Part 3 – Funding Requirements

As mentioned previously, Part 3 of Title I establishes the minimum funding requirements for plans. Part 3 of Title I applies to all plans other than (i) employee welfare benefit plans; (ii) certain insurance funded plans; (iii) top hat plans; (iv) individual account plans (i.e., a 401(k) plan); (v) plans for the benefit of the employees of certain tax exempt organizations; (vi) individual retirement accounts or annuities; and (vii) excess benefit plans.[69] Generally, this means that Part 3 only applies to defined benefit plans and money purchase pension plans.

The Act requires that each plan subject to Part 3 meet certain minimum funding standards, and applies special rules to multiemployer plans (i.e., collectively-bargained plans).[70] A single-employer defined benefit plan generally is treated as satisfying the minimum funding standards for a plan year if the employer makes contributions to or under the plan for the plan year which, in the aggregate, are not less than the minimum required contribution under Section 303 of the Act for the plan year.[71] An employer can request a waiver of the minimum funding standards in the case of certain business hardships (for example, the employer is operating at an economic loss, or it is reasonable to expect that the plan will be continued only if the waiver is granted).[72] If a defined benefit plan is considered "at-risk" (under a funding level that is statutorily determined to create a funding risk), endangered or in critical status, then the Act imposes additional funding requirements.[73]

D. Part 4 – Fiduciary Responsibility

Part 4 of Title I sets forth the requirements relating to fiduciary responsibility. This part of the Act generally applies to all plans other than top hat plans.[74] Every employee benefit plan must have one or more named fiduciaries identified in the plan documents. A fiduciary is anyone who exercises any discretionary authority or discretionary control respecting management of the plan or has discretionary authority or discretionary responsibility in the administration of the plan.[75] Even if a person is not named as a fiduciary, if he or she exercises discretion, authority, or control of the plan's assets, he or she will be a fiduciary. Common examples of fiduciaries with respect to an employee benefit plan include: (i) the plan's trustee(s); (ii) the plan administrator (which, if the plan merely says "the company," will be the board of directors of the company); (iii) an investment manager, and (iv) an investment advisor.

Section 404(c) of the Act provides some protections to fiduciaries for investment losses under individual account qualified plans.[76] If a participant can direct the investment of his account balance and the plan meets the requirements of Section 404(c) of the Act, then no fiduciary will be liable for losses attributable to a participant's exercise of control. In order to receive this protection, the participants must be provided with adequate information so that they can make informed investment decisions about the investments in the plan, and the participants must be given a diverse menu of investment choices under the plan. However, Section 404(c) of the Act does not absolve fiduciaries from the obligation to diversify investments in the plan to minimize risk of loss (see the discussion below regarding a duty to diversify).

All fiduciary liability is "joint and several" for all fiduciaries participating in the breach.

Section 404(a) of the Act sets forth the basic duties of a fiduciary.[77] The four standards of conduct for fiduciaries of qualified retirement plans are: (i) duty of loyalty; (ii) duty of prudence; (iii) duty to diversify investments; and (iv) duty to follow plan documents to the extent they comply with the Act.

1. *Duty of Loyalty*

The Act requires plan fiduciaries to discharge their duties solely in the interest of the participants and beneficiaries, and for the exclusive purpose of providing participants and beneficiaries with benefits and defraying reasonable expenses of administering the plan.[78] This rule is supplemented by the extensive prohibited transaction provisions (see discussion below), as well as by Section 403 of the Act, which provides that the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries. The plan administrator should maintain a list of parties-in-interest (i.e., members of the plan sponsor's board of directors generally are among the parties-in-interest) with whom engaging in certain transactions constitute prohibited transactions. Engaging in a prohibited transaction for which there is not an exemption, can result in a penalty of up to 20% of the amount involved and being required to reverse the transaction. Parties-in-interest include, but are not limited to, fiduciaries to the plan; the employer whose employees are covered by the plan; persons providing services to the plan; the plan administrator; an officer, trustee, custodian or counsel to the plan; certain owners of 50% or more of the employer; employees, officers, directors or 10% shareholders of the employer maintaining the plan; and certain other related parties. For example, the plan should not purchase and lease back to the employer its office buildings or other real or personal property unless it obtains a prohibited transaction exemption covering the transactions. Parties-in-interest cannot represent both themselves and the plan in a transaction with the plan.

Fiduciaries breach the exclusive benefit rule when they mismanage or divert plan assets to parties in interest or individuals who are not participants in or beneficiaries of the plan, and when they fail to take sufficient steps to collect amounts owed to the plan (e.g., failing to follow up on an employer who fails to deposit the employee salary reduction contributions as soon as they become identifiable). Fiduciaries also breach the exclusive benefit rule when they act in their own best interests or in the interests of the employer when dealing with the plan's assets, or when their dealings with the plan are not in the best interest of the plan's participants. A trustee may not deal with the assets of the plan in his own interest (e.g., a fiduciary may not negotiate on behalf of himself or his employer against himself as trustee for the plan to sell the plan investments or services).

On the other hand, fiduciaries do not violate their duty to act for the exclusive benefit of participants and their beneficiaries by taking action which, after careful investigation, would best promote the interests of participants just because the action might incidentally benefit the employer or themselves as employees or officers of the employer. However, fiduciaries have a duty to avoid placing themselves in a position where their acts as employees or officers would prevent their functioning in complete loyalty to the participants. If a transaction involves a substantial conflict of interest, fiduciaries should either (i) resign in favor of a neutral fiduciary for that particular transaction, or (ii) employ independent legal and investment counsel for advice and conduct an intensive, independent and scrupulous investigation of the facts regarding the particular transaction, and verify that the contemplated transaction is not a prohibited transaction with a party-in-interest for which there is no statutory or class exemption.

When faced with dual loyalties, in order to establish that the fiduciary acted in the best interests of participants, a fiduciary should document that its actual deliberations, discussions, and/or interpretations of the plan provisions. In addition, the fiduciary should document that it investigated alternative actions and relied on outside advisors before taking action. The advice of outside advisors should be in a written document to preserve the record of the advice. Fiduciaries bear a risk of liability when they act with dual loyalties without obtaining the impartial guidance of a disinterested outside advisor to the plan.

Use of plan assets in a contest for corporate control, either as a defensive mechanism or as part of the takeover attempt, presents a particular test of loyalty for plan fiduciaries. Violations of the exclusive benefit rule occur where plan fiduciaries, actively engaged in control contests with substantial interests in them, invest the trust's assets in companies involved in the contests without making intensive, independent and scrupulous investigation of investment options open to the trust. At a minimum, fiduciaries must seek independent advice, and if they face substantial potential conflicts, fiduciaries may need to resign temporarily as mentioned above, and have an independent fiduciary appointed.

It is important to document the discussions and deliberations which demonstrate the fiduciaries' process and considerations so that there is a record of the fiduciaries' intent and procedural compliance.

Out of the duty of loyalty also flows the duty to communicate truthfully to the plan participants and beneficiaries regarding their benefits under the plan.[79] Making intentional statements about the future of benefits is an act of plan administration and thus a fiduciary act.[80]

2. *Duty of Prudence*

The duty of prudence requires a fiduciary to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. In other words, a fiduciary must act reasonably in light of the circumstances.

A fiduciary may satisfy the prudence requirements by giving "appropriate consideration" to the facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved and act accordingly. "Appropriate consideration" includes a determination by the fiduciary that the particular investment is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain and such other factors as (i) the composition of the portfolio with regard to diversification; (ii) the liquidity of the portfolio; and (iii) the projected return of the portfolio. Another appropriate consideration is the expected return on alternative investments with similar risks available to the plan. However, prudence is not analyzed in terms of the actual performance of any particular investment but rather in terms of the anticipated total performance of the portfolio.

Prudence is measured by analyzing the process used in selecting an investment as opposed to the investment's overall performance. Evaluating prudence involves the examination of the scope and diligence of the fiduciaries' investigation, and measuring their performance for consistency with the needs and purposes of the plan. The deliberations and decisions regarding the selection of investments should be documented to make a record of the fiduciaries' prudent actions and processes. Any advice received on investment selection or diversification from outside advisors also should be documented. Maintaining a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the duty of prudence. Following the investment policy in selection of the investments and updating it as needed so that the fiduciaries follow the plan's investment policy is an important part of documenting the fiduciaries' prudence.

Circumstances may require that fiduciaries secure independent advice concerning their options in order to comply with the Act's prudence requirements. Such advice must be weighed carefully by the fiduciaries. Fiduciaries should review the data gathered by an advisor to assess its significance and to supplement it where necessary. The fiduciaries' core obligation is making an independent inquiry before investing. Thus, the key, upon review, will be reviewing the documentation of the fiduciaries' decision-making process. Fiduciaries should request full disclosure of all fees and direct or indirect compensation the plan's service providers or investment advisers receive as the result of their relationship with the plan as well.

The fiduciaries should consider retaining professional investment advice to select and monitor investment performance if they do not have sufficient investment expertise. The fiduciaries should consider the following when selecting investments: comparisons to similar funds, diversification of portfolio, liquidity, projected return, historical returns, investment managers for the funds, expenses and risk related factors.

In addition to acting with care in its own decision-making activities, a fiduciary is required to periodically monitor the activities of any investment manager appointed by such fiduciary as to the management of plan assets. To comply with the duty to monitor, fiduciaries should properly document the activities that are subject to monitoring as well as the actual deliberations, discussions and reviews conducted by the fiduciaries.

3. *Duty of Diversification*

The Act imposes upon a fiduciary a duty to diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. The Act does not provide any particular degree of investment concentration that would violate the diversification requirement, but instead relies on a prudent fiduciary to consider the facts and circumstances surrounding each plan and each investment. In evaluating investment concentration versus diversification, a fiduciary should consider: (i) the purpose of the plan; (ii) the size of the investment; (iii) economic and market conditions; (iv) the type of investment (debt or equity); (v) the geographic dispersion of investments; (vi) the investment distribution among industries; (vii) the dates of maturity; (viii) how the investment fits in the plan's portfolio and with the plan's investment policy; (ix) the fees, including whether or not the fees are reasonable and proper; and (x) if there are any contractual restrictions on liquidity or upon trading that may not be consistent with the plan's liquidity needs or investment policy or which must be communicated to participants so they know the restrictions on making investment election changes with respect to such investments. A fiduciary usually should not invest an unreasonably large proportion of a plan's portfolio in a single security, in a single type of security or in various securities dependent upon the success of a single enterprise or upon conditions in a single locality (e.g., the plan should not invest a large portion of its assets in a single building or in a single business or in a single piece of art work).

4. *Duty to Act In Accordance with Plan Documents*

The Act provides that fiduciaries must discharge their duties in accordance with the documents and instruments governing the plan insofar as they are consistent with the Act. The fiduciary must determine if the plan documents are consistent with the Act. A fiduciary breaches its duty to follow the plan if it disregards the plan without showing a reason why the plan should not be followed. However, a fiduciary does not breach its duty to follow the plan if it fails to follow the plan simply because of an erroneous interpretation made in good faith.

5. *Prohibited Transactions and Disclosure*

A fiduciary to a qualified retirement plan must not only comply with the duties described in paragraphs 1 through 4 above, but it also must not permit the plan to engage in any prohibited transactions, and must be careful in making disclosures to participants or beneficiaries. A person or group who has the authority to appoint and remove a fiduciary to a plan also has the duty to monitor such fiduciary's performance. The power to appoint and remove a fiduciary to an employee benefit plan has been found to make the party or group with such power also a fiduciary to the plan.

The Act prohibits fiduciaries from allowing certain transactions between the plan and a party in interest. Specifically, the plan and a party-in-interest may not enter into the following transactions:

- sale or exchange, or leasing of any property between the plan and a party-in-interest;
- lending of money or other extension of credit between the plan and a party-in-interest;
- furnishing of goods, services, or facilities between the plan and a party-in-interest;
- transfer to, or use by or for the benefit of, a party-in-interest, of any assets of the plan;
- acquisition of employer securities or employer real property in an amount greater than 10% of plan assets;
- a fiduciary self-dealing (dealing with the plan's assets for the benefit of his own interests);
- a fiduciary acting in any capacity and dealing with the plan on behalf of a party adverse to the plan or its participants and beneficiaries; or
- a fiduciary personally receiving consideration from any party dealing with the plan in a transaction that involves the plan's assets.

A party in interest is basically any party providing services to the plan, the employer of employees covered by the plan, a fiduciary of the plan or any party owning directly or indirectly a certain percentage of the employer, and a number of other related individuals (e.g., directors, shareholders and officers) and related entities. Fiduciaries must act with prudence in investigating whether a person is a party in interest. As a result, in a transaction, fiduciaries must review whether the transaction involves a party in interest. The plan should identify its parties in interest (the list of parties in interest is requested in some governmental audits).

Engaging in a prohibited transaction results in the imposition of a 15% excise tax on the amount involved in a prohibited transaction. Such excise tax can be increased to 100% if the prohibited transaction is not timely corrected.

Part 4 also creates disclosure obligations in addition to those expressed in Part 1. A Part 4 obligation would focus on the extent to which the duty to act solely in the interest of plan participants and beneficiaries encompasses a collateral duty to provide participants and beneficiaries with information they need to exercise their rights effectively under an employee benefit plan, to protect their rights under ERISA and to make informed decisions.

A fiduciary has the duty to inform participants and beneficiaries of their rights. A fiduciary must give complete and accurate information in response to participants' questions, though it does not have to disclose its internal deliberations. Fiduciaries violate their duties when they participate knowingly and significantly in deceiving a plan's participants and beneficiaries in order to save the employer money at the participants' expense.

E. <u>Part 5 – Administration and Enforcement</u>

Part 5 of Title I sets forth the criminal and civil penalties that apply for violations of the Act, as well as the mechanism available to the enforcement agencies to compel compliance with the Act.

If any person willfully violates any provision of Part 1 of Title I, the individual will face, upon conviction, fines up to $100,000 and imprisonment of up to ten years.[81] If the violation is an entity other than an individual, then the fine increases to a potential maximum of $500,000.[82]

Part 5 of Title I also permits participants, beneficiaries, the Department of Labor and plan fiduciaries to file a civil action to recover benefits under the plan, impose penalties for failure to comply with reporting and disclosure obligations, enjoin and redress any act that violates Title I or the terms of the plan, relief with respect to a fiduciary breach, and enforce the terms of a qualified medical child support order.[83]

With respect to breaches of fiduciary liability, Section 502(l) of the Act requires the Secretary of Labor to assess a civil penalty against a fiduciary who breaches a fiduciary responsibility under, or commits a violation of, Part 4 of Title I of the Act or any other person who knowingly participates in such breach or violation. The penalty under Section 502(l) of the Act is equal to 20% of the "applicable recovery amount" paid pursuant to any settlement agreement with the Secretary or ordered by a court to be paid in a judicial proceeding instituted by the Secretary of Labor under Section 502(a)(2) or (a)(5) of the Act. The Secretary has discretion to waive or reduce the penalty if he determines in writing that either: (1) the fiduciary or other person acted reasonably and in good faith; or (2) it is reasonable to expect that the fiduciary or other person will not be able to restore all losses to the plan or any participant or beneficiary of such plan without severe financial hardship unless such waiver or reduction is granted. The penalty imposed on a fiduciary or other person with respect to any transaction is reduced by the amount of any penalty or tax imposed on such fiduciary or other person with respect to such transaction under Section 502(l) of the Act or Code Section 4975.

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[1] *See* James A. Wooten, 'The Most Glorious Story of Failure in the Business:' The Studebaker-Packard Corporation and the Origins of ERISA, 49 Buff. L. Rev. 683 (2001).

[2] ERISA § 3(3).

[3] ERISA § 4(b).

[4] DOL Adv. Op. No. 89-10A (July 6, 1989), citing 29 C.F.R. § 2510.3(k) (excluding from covered "scholarship funds" tuition and education expense refund programs that are paid from general employer assets). But *See In re General Motors Corp.*, 3 F.3d 980 (6th Cir. 1993) (employee assistance program was an employee welfare benefit plan).

[5] 29 C.F.R. § 2510.3-3(b).

[6] 29 C.F.R. § 2510.3-3(c). e.g., *Meredith v. Time Ins. Co.*, 980 F.2d 352 (5th Cir. 1993) (insurance plan purchased by sole proprietor, covering only herself and her spouse, is not an ERISA plan); *Fugarino v. Hartford Life & Accident Ins. Co.*, 929 F.2d 178, 1895 (6th Cir. 1992), *cert. denied*, 113 S. Ct. 401 (1993) (a plan whose sole beneficiaries are the company's owners cannot qualify as a plan under ERISA); *Ehrlich v. Howe*, 16 EBC 1128 (S.D.N.Y. 1992) (partner may be able to show he lacked independent control of firm's operations and decision processes and, thus, was essentially an employee). *See Madonia v. Blue Cross & Blue Shield of Virginia*, 11 F.3d 444 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1401 (1994) (plan established when physician operating in corporate form enrolled himself and one employee in insurance plan). *See Nationwide Mut. Ins. Co. v. Darden*, 112 S. Ct. 1344, 1348 (1992) (adopting common law test for determining who qualifies as an "employee" under ERISA).

[7] *See Taggert Corp. v. Life & Health Benefits Admin., Inc.*, 617 F.2d 1208, 1211 (5th Cir. 1980), *cert. denied*, 450 U.S. 1030 (1981) (bare purchase of insurance does not, in and of itself, establish an ERISA plan).

[8] *Donovan v. Dillingham*, 688 F.2d 1367, 1375 (11th Cir. 1982) (en banc) (limiting Taggert to its facts); *See Randol v. Mid-West Nat'l Life Ins. Co.*, 987 F.2d 1547 (11th Cir.), *cert. denied*, 114 S. Ct. 180 (1993) (plan created where employer established system for withholding premiums from wages and contributed a nominal sum per employee for premiums); *Kidder v. H&B Marine, Inc.*, 932 F.2d 347, 353 (5th Cir. 1990) ("payment of premiums on behalf of . . . employees is substantial evidence that a plan, fund or program [was] established"); *Memorial Hosp. Sys. v. Northbrook Life Ins. Co*., 904 F.2d 236, 240-41 (5th Cir. 1990) (employer "established" a plan by paying insurance premiums for employees and seeing reimbursement through payroll deductions); *Marshall v. Bankers Life & Cas. Co*., 2 Cal. 4th 1045, 1051 (1992) (employer establishes ERISA plan by purchase of health insurance even though plan is unwritten and employer has no role in administration of benefits under policy).

[9] ERISA § 3(1).

[10] 29 C.F.R. § 2510.3-1(b).

[11] 29 C.F.R. § 2510.3-1(b) & (k). But compare *UAW, Local 33 v. R.E. Dietz Co*., 996 F.2d 592 (2d Cir. 1993), *California Hosp. Ass'n v. Henning*, 770 F.2d 856 (9th Cir. 1985), *cert. denied*, 477 U.S. 904, 91 L. Ed. 2d 564 (1986), and *Golden Bear Family Restaurants, Inc. v. Murray*, 144 Ill. App. 3d 616, 7 EBC 2203 (1986) (no ERISA coverage of unfunded vacation pay plans), with *Holland v. National Steel Corp*., 791 F.2d 1132, 1135-36 (4th Cir. 1986), and *Blakeman v. Mead Containers*, 779 F.2d 1146, 1149 (6th Cir. 1985) (ERISA covers unfunded vacation pay plans).

[12] 29 C.F.R. § 2510.3-1(c)-(j).

[13] *See Johnson v. Watts Regulatory Co.*, 63 F.3d 1129, 1133 (1st Cir. 1995) (group insurance programs for accidental death, dismemberment and permanent disability qualified as a program of employee benefits under ERISA).

[14] *See* U.S. Department of Labor Opinion Letters 93-2A (January 12, 1993) and 85-23A (June 10, 1985); 82-44A (August 27, 1982).

[15] U.S. Department of Labor Opinion Letter 83-37A (July 18, 1983).

[16] *See, e.g.*, U.S. Department of Labor PWPB Opinion Letter 93-27A (October 12, 1993); U.S. Department of Labor PWPB Opinion Letter 93-20A (July 16, 1993); U.S. Department of Labor PWPB Opinion Letter 92-18A (September 30, 1992).

[17] *See Martin Marietta Energy System, Inc. v. Industrial Comm'n of Ohio*, 843 F. Supp. 1206, 1211 (S.D. Ohio 1994) (finding disability benefits constituted a payroll practice even though they amounted to less than employees' regular wage). *See also Abella v. W.A. Foote Memorial Hospital, Inc.*, 740 F.2d 4, 5 (6th Cir. 1994) (noting that the administrative petition of a statute by those entrusted with its enforcement is entitled to great weight in finding sick leave benefits not covered by ERISA).

[18] *See Williams v. Wright*, 927 F.2d 1540, 1544 (11th Cir. 1991) (the payment of benefits out of an employer's general assets does not affect the threshold question of ERISA coverage), U.S. Department of Labor Opinion Letters 78-18 (September 20, 1978) and 79-75 (October 29, 1979).

[19] *Stoltz v. Fenn Mfg. Co.*, 27 EBC 2058 (D.C. Conn. 2002).

[20] *Id.*

[21] *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 12 (1987).

[22] *See e.g., Simas v. Quaker Fabric Corp.*, 6 F.3d 849 (1st Cir. 1993) (state "tin parachute" law requiring payment of severance benefits to employees losing jobs within specified periods before or after a corporate takeover preempted because required establishment of a plan); *Bogue v. Ampex Corp.*, 976 F.2d 1319 (9th Cir. 1992), *cert. denied*, 113 S. Ct. 1847 (1993) (employer's agreement to pay one-time lump-sum severance benefit to executives if company was taken over and executive did not obtain equivalent employment, created a plan). But *see James v. Fleet/Norstar Fin. Group*, 992 F.2d 463 2d Cir. 1993) (employer's promise to pay severance to each employee who remained until the facility was closed was not an employee plan); *Fontenat v. NL Indus., Inc.*, 953 F.2d 960 (5th Cir. 1992) (golden parachute program providing severance payments to corporate executives terminated as result of takeover was not a plan because did not require administrative scheme to meet employer's obligation).

[23] *Belanger v. Wyman-Gordon Co*., 19 EBC 2307 (1st Cir. 1995).

[24] 29 C.F.R. §2510.3-2(b).

[25] See DOL Adv. Op. Nos. 83-47A (Sept. 13, 1983); 81-75A (Oct. 6, 1981); 81-8A (Jan. 12, 1981); but See DOL Adv. Op. No. 81-37A (Mar. 31, 1981) (program paying severance benefits based on length of service only on plant relocation or closing but without age or service minimum was a welfare plan).

[26] ERISA § 3(2).

[27] ERISA § 3(34).

[28] ERISA § 3(35).

[29] ERISA § 3(16)(B).

[30] ERISA § 3(16)(A).

[31] ERISA § 3(5).

[32] See 29 U.S.C. § 1051 (excepting such plans from ERISA's vesting and participation requirements); 29 U.S.C. § 1801(a)(3) (excepting such plans from ERISA's funding requirements) and 29 U.S.C. § 1101(a)(1) (excepting such plans from ERISA's fiduciary responsibility requirements).

[33] See DOL Advisory Opinion 90-14A. *See also In re New Valley Corp.*, 89 F.3d 143, 148 (3d Cir. 1996), *cert. denied*, 519 U.S. 1110 (1997) (holding that a legitimate top hat plan must cover a select group of employees who are only high-level employees); *Hollingshead v. Burford Equip. Corp.*, 747 F. Supp. 1421, 1429 (M.D. Ala. 1990) (stating that the fact that an employer intends the plan to be a reward to "key" employees does not satisfy the degree of selectivity contemplated by the statutes); and *Bigola v. Fischback Corp.*, 898 F. Supp. 1004, 1015 (S.D.N.Y. 1995), aff'd, 101 F.3d 108 (2d Cir 1996) (stating that the statute contemplates that a top hat plan will be for the benefit of only high-ranking employees).

[34] *Carrabba v. Randall's Food Markets, Inc.*, 38 F. Supp.2d 468, 476, 478 (N.D. Tex. 1999), aff'd, 252 F.3d 721 (5th Cir. 2001), *cert. denied*, 534 U.S. 995 (2001).

[35] *Id.* at 475.

[36] *Id.* at 478.

[37] *Id.*

[38] *See Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283 (2d Cir. 2000) (holding that the group of eligible employees was highly compensated because, when it compared the average salary of all participants to the average salary of all Extebank employees, it found that the average salary of all participants was double that of the average salary of all other Extebank employees). See also DOL Advisory Opinion 75-64 (holding that an unfunded deferred compensation plan covering four percent of the company's workforce and covering employees whose compensation was 68% higher than the company's workforce was a top hat plan).

[39] *Demery v. Extebank Deferred Compensation Plan (B)*, 216 F.3d 283 (2d Cir. 2000).

[40] *Alexander v. Brigham & Women's Physicians Org., Inc.*, 2006 U.S. Dist. LEXIS 93059 (D. Mass. Dec. 26, 2006).

[41] *Id.* at *20.

[42] *Id.* at *22.

[43] *Id.* at *22-23.

[44] *IT Group, Inc. v. Bookspan (In re IT Group, Inc.)*, 305 B.R. 402, 410 (Bankr. D. Del. 2004) aff'd 448 F.3d 661 (3d Cir. Del. 2006).

[45] *Id.* at 411.

[46] ERISA § 104.

[47] *Id.*

[48] ERISA § 104.

[49] ERISA § 101(f).

[50] ERISA § 101.

[51] 29 C.F.R. § 2520.104-21.

[52] 29 C.F.R. § 2520.104-43.
[53] ERISA § 101(d)(1).
[54] ERISA § 101(d)(2).
[55] ERISA § 101(m).
[56] ERISA § 201.
[57] ERISA § 202(a)(1)(A).
[58] ERISA § 202(a)(1)(B).
[59] ERISA § 202(a)(2).
[60] ERISA § 203.
[61] *Id.*
[62] *Id.*
[63] ERISA § 204(b)(1)(A).
[64] ERISA § 204(b)(1)(B).
[65] ERISA § 204(b)(1)(C).
[66] ERISA § 205.
[67] *Id.*
[68] ERISA § 206(d).
[69] ERISA § 301.
[70] ERISA § 302.
[71] ERISA § 302(a).
[72] ERISA §§ 302(c) and 303.
[73] ERISA § 303(i).
[74] ERISA § 401(a).
[75] ERISA § 3(21)(1).
[76] ERISA § 404(c).
[77] ERISA § 404.
[78] ERISA § 404.
[79] *Varity Corp. v. Howe*, 516 U.S.489 (1996).
[80] *Id.*
[81] ERISA § 501.
[82] *Id.*
[83] ERISA § 502.

TAX PLANNING FOR REAL ESTATE

State Bar of Texas Tax Section

Tax Law in a Day

February 6, 2015

Dallas, Texas

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TAX PLANNING FOR REAL ESTATE

I. SCOPE OF ARTICLE

The objective of this paper is to discuss the most common tax issues that arise in today's dynamic real estate market. This paper provides an overview of the most common topics in a variety of areas. First, we will discuss various topics that affect entity selection and structuring for real estate companies. Then, we will look at issues affecting residential home owners, and recent changes to the tax laws that affect personal ownership. The paper will then discuss tax issues associated with the acquisition, development, maintenance and sale of real estate. Finally, we will briefly discuss issues related to non-US investment in the US real estate market and State taxes applicable to real property activities. This primer will help you get started on the right road to represent your clients in a cost-effective and competent manner, regardless of your prior level of knowledge or experience with tax planning for real estate investments.

II. ENTITY SELECTION

A. Application of Texas Franchise Tax. The Texas franchise tax (or margins tax) is a privilege tax imposed on certain entities organized under the laws of the State of Texas or doing business in Texas. The franchise tax applies to "taxable entities" that have limited liability protection under Texas law, or the law of their state of formation for foreign entities. Texas Tax Code Section 171.0002(a) defines a "taxable entity" as a partnership (both general and limited unless otherwise excluded), limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture (except joint operating or co-ownership arrangements electing out of partnership treatment under Code Section 761(a)), joint stock company, holding company, or any other legal entity. For Texas franchise tax purposes, an entity that can file as a disregarded entity for federal tax purposes is not a sole proprietorship (and therefore exempt from the franchise tax). Notwithstanding the foregoing, "taxable entities" (a) with no Texas gross receipts, or (b) with total annual revenue less than or equal to $1,080,000 are not subject to the franchise tax, *i.e.*, the $1MM exception indexed for inflation. Additionally, a taxable entity with a tax liability of less than $1,000 is not subject to the franchise tax.

1. Entities Not Considered "Taxable Entities". Texas Tax Code Section 171.0002(b) provides that the following are not considered "taxable entities":

a. a sole proprietorship (unless formed under a foreign statute that provides for limited liability);

b. a general partnership where the direct ownership is entirely composed of "natural persons" and the liability of those persons is not limited;

c. a passive entity, as defined by Texas Tax Code Section 171.0003, and determined on a year-to-year basis;

d. an entity that is exempt from taxation under Subchapter B of Section 171 (e.g., nonprofit organizations);

e. a grantor trust (defined in Code Sections 671 and 7701(a)(30)(E) of the Internal Revenue Code), where all grantors and beneficiaries are natural persons or charitable entities as described in Code Section 501(c)(3);

f. an estate of a natural person, as defined by Code Section 7701(a)(30)(D);

g. an escrow account;

h. a joint operating or co-ownership arrangement meeting the requirements of Treas. Reg. Section 1.761-1(a)(3) that elects out of federal partnership treatment;

i. a real estate investment trust ("REIT"), as defined by Code Section 856 and its "qualified REIT subsidiary" entities, as defined by Code Section 856(i)(2); *provided, that* (i) the REIT holds interests in limited partnerships or other entities that are taxable entities and directly hold real estate; and (ii) the REIT does not directly hold real estate, other than real estate it occupies for business purposes, subject to certain exceptions;

j. a real estate mortgage investment conduit ("REMIC"), as defined by Code Section 860D;

k. a nonprofit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;

l. a trust qualified under Code Section 401(a) (e.g., retirement plans);

m. a voluntary employees' beneficiary association/trust or other entity that is exempt under Code Section 501(c)(9); or

n. certain corporations or other entities which qualify as (a) insurance organizations, title insurance companies or title insurance agents, authorized to engage in the insurance business in Texas and paying an annual tax under Chapters 4 or 9 of the Texas Insurance Code, or (b) farm mutuals, local mutual aid associations, and burial associations.

As noted above, a joint venture or co-ownership arrangement (such as a tenant-in-common arrangement) which is not a partnership for federal tax purposes should not be subject to the franchise tax. Rather, the members of the venture, if taxable entities, should be subject to the tax on their share of the gross receipts, and avail themselves of their share of the compensation expenses or costs of goods sold.

2. Passive Entity. Pursuant to Section 3.582 of the Texas Administrative Code and Section 171.0003 of the Texas Tax Code, a passive entity must be (a) a general or limited

partnership, a limited liability partnership, or a trust other than a business trust for the entire period on which the tax is based, and (b) the entity's federal gross income consists of at least 90% "passive income".

a. Passive Income. Texas Tax Code Section 171.0003(c)(2) defines passive income as any of the following: (i) dividends (which presumably includes net distributive income from subchapter S corporations), interest, foreign currency exchange gain, periodic and non-periodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company, (ii) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero; (iii) net capital gains from the sale of real property; (iv) net gains from the sale of commodities traded on a commodities exchange; net gains from the sale of securities; and (v) royalties, bonuses, or delay rental income from mineral properties and income from other non-operating mineral interests. Note that passive income only includes "net capital gains from the sale of real property" and not "gains from the sale of real property". Therefore, to the extent the sale of real property produces ordinary income, recapture, or Section 1231 gain, this income may not qualify as passive income. The Texas Comptroller has stated that recapture under Sections 1245, 1250 and 1254 will be considered active income.

i. Dealer Status. See VII. A. of this Outline for the discussion regarding whether a taxpayer is considered real estate investor or a real estate developer. To the extent a taxpayer is considered a dealer, query whether the net capital gains from the sale of the dealer's real property is still considered passive for franchise tax purposes. In this regard, remember that, for purposes of defining long term capital gain, Code §1221(a) defines a "capital" asset as property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but specifically excludes "*. . . property held by the taxpayer primarily for sale to customers in the ordinary course of his or her trade or business*". Similarly, Code §1231(a)(3)(A) says "section 1231 gain" includes any recognized gain on the sale or exchange of *property used in the trade or business,* and Code §1231(b)(1), in defining "property used in the trade or business," excludes *property of a kind which would properly be included in inventory of the taxpayer . . . .*" Consequently, it appears gains derived from the sale of "dealer" real estate would not be capital gain, and thus, would not constitute "passive" income for purposes of qualifying a partnership as a passive partnership for Texas franchise tax exemption purposes.

ii. Net Investment Income. Compare "passive income" under Texas tax laws to "net investment income" subject to the 3.8% Medicare tax discussed in II. F. of this Outline.

b. Not Passive Income. Texas Tax Code Section 171.0003(d) specifically states that passive income does NOT include the following: (i) rent; (ii) income received by a non-operator from mineral properties under a joint operating agreement, if the non-operator is a member of a combined group, and another member of that group is the operator under the same joint operating agreement; (iii) gains from the sale of tangible personal property, such as equipment, art work or collectibles; (iv) gain from the sale of a 50% or greater interest in a corporation, partnership or LLC; or (v) income, which is neither active nor passive.

c. Blocker Subsidiaries. There has been some discussion as to how to segregate rental property or other active businesses from an otherwise passive partnership for Texas margin tax purposes so that partnership can qualify as a passive partnership exempt from the franchise tax. In this regard, tax planners are suggesting that rental property or other active business assets be dropped into a subsidiary partnership or LLC (which would be subject to the franchise tax), thereby ensuring that the parent partnership could qualify as a passive entity exempt from the tax (since the distributive income from the subsidiary partnership or LLC would qualify as passive income). There are risks associated with this structure. Texas Administrative Code Rule 3.582 defines "federal gross income" for purposes of determining passive versus active income by reference to Code Section 61(a), which includes a parent entity's share of a partnership's federal gross income. Note however that Rule 3.582(c)(2)(B) uses the phrase "distributive shares of partnership income" rather than "distributive shares of partnership *gross* income", negating or at least softening the reference to Section 61(a).

d. Selling Real Estate. Another franchise tax planning technique includes the reorganization of a real estate owning corporation or limited liability company into a limited partnership immediately before a sale of the underlying real estate. The sale transaction would be structured as an installment sale so all the gain other than recapture income would be taxable in the immediately following tax year, thereby qualifying the new partnership as a passive partnership.

B. Corporations.

1. No Long-Term Capital Gains Rate. Long-term capital gains tax rates are not applicable to C corporations. Instead, all C corporation income is taxed at regular corporate rates or at the Section 1202 flat tax of 35% on net capital gains (i.e., long term capital gains less net short term capital losses). The regular income tax rates for a "C" corporation are:

a. 15% on the first $50,000 of income;

b. 25% on $50,001-$75,000 of income;

c. 34% on $75,000-$100,000 of income;

d. 39% on $100,000-$335,000 of income;

e. 34% on $335,000-$10,000,000 of income;

f. 35% on $10,000,000-$15,000,000 of income;

g. 38% on $15,000,000-$18,333,333 of income; and

h. 35% on income over $18,333,333.

2. Personal Holding Companies. The personal holding company ("PHC") tax is a 20% penalty tax imposed on certain kinds of passive income that is retained by a closely-held C

corporation. See Code Sections[1] 542, 541 and 552. The PHC tax is in addition to the ordinary corporate income tax rates. The PHC tax generally applies to closely-held corporations where at least 60% of the corporation's (adjusted gross) income is comprised passive income, including interest, dividends, royalties, rent or trust income. The PHC tax can be avoided by paying dividends to stockholders within 90 days after the IRS determines that PHC tax is due. Code Section 547.

a. Exception for Real Estate Holding Companies. Under Section 543(a)(2), rental income is not classified as personal holding company income if the corporation passes the following 2 tests for the relevant tax year, (i) at least 50% of the corporation's "adjusted ordinary gross income" is comprised of "adjusted income from rents" and (ii) the corporation has no more than 10% of any other kind of PHC income (determined by considering all real estate rental income) that has not been paid out (or deemed paid out) as dividends. "Adjusted income from rents" means the excess of rental income over real estate rental deductions, including deductions for depreciation, interest expense, property taxes and rental expenses allocable to the generation of real estate rental income.

3. Using Real Property to Avoid Double Corporation Taxation. A stockholder can avoid double taxation by leasing individually owned real property to his or her corporation. The rent paid to the stockholder is deductible by the corporation and classified as taxable income to the stockholder, who is only subject to one level of tax. Additionally, the depreciation or amortization deductions derived from the property may completely offset the rental income received from the corporation.

C. Passive Loss Rules.

1. General. Code Section 469 limits a taxpayer's use of passive losses to offset income. Generally, deductions attributable to passive activities in a taxable year are limited to a taxpayer's passive income and cannot be used to offset portfolio income or income which is derived from "active" activities, including the taxpayer's salary and other active business income. A passive activity is any trade or business in which the taxpayer does not "materially participate". Section 469(c)(1); Treas. Reg. 1.469-1T(e)(1)(i). Additionally, the following are considered "active" activities (1) a working interest in an oil or gas well which is held directly or through an entity that does not limit liability (i.e., a general partner interest in a partnership); (2) the rental of residential property that the taxpayer also uses for personal purposes for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental; (3) trading personal property for the account of those who own interests in the activity; and (4) rental real estate activities in which the taxpayer materially participated as a real estate professional. See Treas. Reg. 1.469-1T(e). In the partnership context, the determination of whether an investment in a partnership is passive or active must be made at the partner level rather than at the partnership level. Although a taxpayer may continue to deduct passive losses from income derived from passive investments, he

[1] All references to "Sections" are to the corresponding section in the Internal Revenue Code of 1986, as amended from time to time. References to the regulations or a "Reg." means the regulations promulgated under certain Sections of the Internal Revenue Code.

may not shelter ordinary income by accumulating losses through business investments in which he does not materially participate. As discussed above, rental activities are considered per se passive activities, unless performed by a qualified real estate professional. See Section C.2 below.

a. Portfolio Income. Under Section 469, portfolio income is distinguished from income from passive activities. Portfolio income is generally excluded in determining a taxpayer's income or loss from passive activities. Dividends on corporation stock, dividends from a real estate investment trust, interest on debt obligations, and royalties from the licensing of property are examples of portfolio income. Gains attributable to the disposition of property that is held for investment and is not passive activity are also included in portfolio income. In addition, gains or losses from the sale of an interest which normally produces portfolio income or loss will be treated as portfolio income or loss. Taxpayers are not permitted to offset portfolio income with passive losses. Similarly, passive income cannot be offset by portfolio losses.

2. Rental Activities of Real Estate Professionals. As discussed above, rental activities operated by qualifying real estate professionals are not per se passive (as they are for non-professionals). Instead, the real estate professional is subject to the material participation test (described below) in order to determine if the activities are passive or active. A taxpayer qualifies as a real estate professional if: (i) more than one-half of the personal services performed in the taxpayer's businesses are performed in real property business(es) in which the taxpayer materially participates; and (ii) the taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates. Section 469(c)(7)(B). For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation (discussed below) is considered separately with respect to each rental property unless the taxpayer elects, by filing a statement with his original income tax return for the tax year, to treat all interests in rental real estate as a single rental real estate activity. A closely-held C corporation will qualify for the real estate professional exception if more than 50% of its gross receipts for the tax year are derived from real property trades or businesses in which the corporation materially participates. Section 469(c)(7)(D). If one or more of the interests are held by the real estate professional as a limited partnership interest, then the combined rental real estate activity will be treated as a limited partnership interest for purposes of determining material participation and the taxpayer will not be treated as materially participating in the combined rental real estate activities unless the taxpayer materially participates in the activity under the tests described below. Reg. § 1.469-9(f)(1).

a. Harnett v. Commissioner, T.C. Memo. 2011-191 (August 11, 2011). In *Harnett*, the taxpayer founded a savings and loan association to provide financing to customers of his real estate development company. In 2005, the taxpayer resigned as CEO but continued to work as a consultant to the association and served as chairman of the board. The taxpayer also stopped renting real estate properties and had begun trying to sell them. The taxpayer stated that he spent most of his time on real estate activities and only ten (10) hours a month at the bank, despite his positions of chairman and/or CEO for the tax years at issue, as well as a six-figure salary. The court found that the taxpayer's unsubstantiated testimony did not qualify the taxpayer as a real estate professional as it did not establish that the taxpayer had performed more than 750 hours of service during the tax years at issue. Therefore, the taxpayer's real estate losses were passive and could not offset non-passive income.

b. Moss v. Commissioner, 135 T.C. 18 (2010). In *Moss*, the Tax Court held that the time the taxpayer was "on call" to provide services on behalf of the rental properties would not be considered in determining whether the taxpayer met the 750-hour real estate professional requirement. The taxpayer did not actually perform any services in furtherance of the rental properties during the "on call" hours. Additionally, the taxpayer had a full-time job working at a nuclear power plant that included "on call" time in case of an emergency. Therefore, the losses from the rental activities were subject to Section 469(i) and thus deductible only to the extent of passive income.

c. Miller v. Commissioner, T.C. Memo. 2011-219 (September 18, 2011). In *Miller*, the taxpayers owned 6 rental real estate properties, for which the taxpayers performed significant construction and managed services. The Tax Court found that the taxpayer spent more time on the real estate activities in which he materially participated than he did in his day job, and that he met the 750 hour requirement under Section 469(c)(7) to qualify as a real estate professional. Note that the taxpayer does not need to be a licensed agent or broker in order to qualify as a real estate professional. See *Agarwal v. Commissioner*, TC Summary Opinion 2009-29 (March 2, 2009).

3. Material Participation. In general, material participation requires a taxpayer's involvement in the operations of an activity on a regular, continuing and substantial basis. Section 469(h)(1); *Goshorn v. Commissioner*, T.C. Memo. 1993-578. The participation of a taxpayer's spouse is taken into account in determining whether the taxpayer materially participates. Section 469(h)(5); Treas. Reg. 1.469-5T(f)(3).

a. Temporary Regulations. After the passive activity rules were enacted, the IRS promulgated Treas. Reg. 1.469-5T(a) to specify what constituted material participation. The taxpayer must be able to prove his or her participation in the subject activity. See II. C. 9. below regarding substantiation. Under these temporary regulations, a taxpayer is considered to be materially participating in an activity if, during any given tax year, the taxpayer satisfies any one of the following tests:

i. the individual participates in the activity for more than 500 hours during the tax year;

ii. the individual's participation in the activity for the tax year constitutes substantially all the participation in the activity of all individuals for the year;

iii. the individual participates in the activity for more than 100 hours and his participation for the tax year is not less than the participation of any individual for the year;

iv. the activity is a "significant participation activity" and the individual's aggregate participation in all his significant participation activities during the year exceeds 500 hours. A significant participation activity is a trade or business in which the taxpayer participates for more than 100 hours during the tax year, but does not materially participate under any of the other six tests;

v. the individual materially participates in the activity for any five tax years, whether or not consecutive, during the 10 tax years that immediately precede the tax year in question; or

vi. the activity is a "personal service activity", and the individual materially participates in the activity for any three tax years, whether or not consecutive, preceding the tax year in question. A personal service activity is any activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts or consulting or any other trade or business in which capital is not a material income-producing factor.

b. Facts and Circumstances. Material participation can also be satisfied using a facts and circumstances test. Treas. Reg. 1.469-5T(a). Under the temporary regulations, a taxpayer's participation will be considered material if: (i) the individual participates in the activity on a regular, continuous and substantial basis during the tax year in question, and (ii) the taxpayer participates in the activity for more than 100 hours during the tax year. Temp. Reg. sec. 1.469-5T(b)(2). Under this test, a taxpayer's managements of an activity is not considered material unless (x) other than the taxpayer, no person who performs management services receives compensation treated as earned income; and (y) no other individual performs management services that exceed the services performed and the number of hours spent on such activity by the taxpayer. Treas. Reg. 1.469-5T(b)(2)(ii).

c. Trust Participation.

i. Mattie K. Carter Trust v. U.S. Prior to 2014, only one case had considered whether or not a trust could materially participate. In *Mattie K. Carter Trust v. United States*, a 15,000 acre cattle ranch was owned by a trust, whose trustee reviewed the financial affairs of the ranch, but was not otherwise involved in the day-to-day operations of the ranch. 256 F. Supp. 2d 536 (N.D. Tex. 2003) (mem. op.). The trustee hired several employees and a manager who oversaw the day-to-day operations. The IRS argued that the trust did not materially participate in the ranch because the trustee was not regularly, continuously and substantially involved in the operations of the ranch. In granting the trust's motion for summary judgment, the court agreed with the trust's argument that a trust, like a corporation, can only act through its agents, employees, and fiduciaries, and that the activities of *all* those persons should be considered for the purposes of determining material participation, not just the trustee.

ii. TAM 200733023. In TAM 200733023, a trust owned an interest in an LLC, which was taxed as a partnership for federal income tax purposes. The special trustee served as the President of the LLC and performed various services for the LLC including budget approval, supervision of financing, as well as direct operational activity. The IRS looked to the legislative history of Section 469(h)(1) in concluding that only the activities of fiduciaries or trustees in their capacity as such should be considered in determining the trust's material participation, not the activities of employees. The IRS concluded that Special Trustees were more in the nature of employees, rather than fiduciaries, and refused to consider the activities of the Special Trustees in determining whether the trust materially participated in the LLC.

iii. Frank Aragona Trust. In *Frank Aragona Trust v. Commissioner*, Frank Aragona created a trust in 1979 to hold his real estate business activities for the benefit of his five children. 142 T.C. 9 (2014). The trust's assets included a wholly-owned LLC which held all of the rental real estate. Three of Frank's children were full-time employees of the LLC. After the grantor's death in 1981, his five children served as co-trustees, together with an independent co-trustee. Two of the children who were employed by the LLC also owned minority interests in other real estate entities in which the trust was the majority owner. The trust claimed that it was materially participated in real estate activities as a real estate professional, and used losses from these activities to offset other non-passive income. The IRS disagreed, arguing that a trust could never qualify as a real estate professional because a trust, as an entity, cannot perform personal services. The IRS also argued that the trust did not materially participate in real estate activity because the employee-trustees were not participating in their role as fiduciaries but were instead acting in their roles as either employees and/or investors.

(a) The Tax Court first ruled that a trust could qualify as a real estate professional because trusts are considered "taxpayers" under Section 469(a)(2)(A). The court noted that a closely-held C-corporation (an entity) could perform personal services through the actions of its agents. Therefore, the trust could perform personal services through the actions of its trustees, who manage the trust's assets in the interest of its beneficiaries. The Tax Court also rejected the IRS's argument that the employee-trustees were acting outside of their fiduciary capacities, finding that state law required fiduciaries to act solely in the best interest of the trust's beneficiaries at all time. The court found that (1) the 3 employee-trustees participated in the trust's real estate operations full-time; (2) the trust's real-estate operations were substantial; (3) the trust has no other types of operations other than real estate; and (4) the employee-trustees handled almost no other businesses on behalf of the trust.

(b) The Tax Court held that the trust materially participated in real-estate activities, despite the fact that two employee-trustees also owned a minority interest in the trust's other real estate holdings. It noted that the interests owned by the trustees were minority interests and that their combined interest did not exceed the interest of the trust in those in related real estate businesses. Note that the IRS did not raise any arguments regarding the trust's failure to satisfy either the "750 hour" test or the "one-half of personal services" test under Section 469(c)(7).

4. Passive Loss Rules As Applied to Limited Partners. As a general rule, a limited partner of a partnership is not considered as materially participating in any activity in which he is a limited partner. However, the temporary regulations under Section 469 provide the following four exceptions:

a. the limited partner participates in the activity for more than 500 hours during the tax year;

b. the limited partner materially participates in the activity for any five tax years, whether or not consecutive, during the ten tax years that immediately precede the tax year in question;

c. the activity is a personal service activity and the limited partner materially participates in the activity for any three tax years, whether or not consecutive, preceding the tax year in question; or

d. the limited partner is also a general partner at all times during the partnership's tax year that ends with or within the individual's taxable year. Temp. Reg. §§ 1.469-5T(e)(2), (e)(3)(ii).

A partnership interest will be classified as a limited partnership interest if either one of the following two conditions is satisfied: (1) the interest is designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the partner's liability is actually limited under the applicable state law; or (2) the liability of the partner for obligations of the partnership is limited under the laws of the state in which the partnership is organized to a determinable fixed amount, such as the partner's capital contributions to the partnership and his obligations to make additional capital contributions. Temp. Reg. § 1.469-5T(e)(3)(i).

5. Passive Loss Rules As Applied to LLC Members. The IRS has asserted that a member in an LLC should be treated the same as a limited partner for purposes of the passive activity loss rules. For example, in *Gregg v. United States*, No. CIV 99-845-AA, 2000 WL 33706361 (D. Or. 11/29/2000), an Oregon federal district court applied the "material participation" test to an individual LLC member and rejected the IRS's contention that all LLC members, like limited partners, should be precluded from meeting the material participation test. Many practitioners were initially reluctant to rely on the Gregg case. Four recent cases have given members of an LLC greater ability to avoid the passive activity loss limitations. See *Garnett v. Commissioner*, 132 T.C. No. 19 (6/30/09); *Thompson v. United States*, 104 A.F.T.R. 2d 209-5124 (Fed. Cl. 7/20/09); *Hagerty v. Commissioner*, TC Summary Opinion 2009-153 (10/08/09); *Newell v. Commissioner*, T.C.M. 2010-23 (Feb. 16, 2010). In *Garnett v. Commissioner*, the taxpayers held a number of direct and indirect interests in LLCs and limited liability partnerships ("LLPs") engaged in business, and the second, third and fourth of these cases only LLC's were involved. The Tax Court and Federal Court of Claims held that LLCs are different from limited partnerships (in that the owners of LLCs are not barred from materially participating in the affairs of the entities) so the ownership interests in the LLCs should not be treated as limited partnership interests for purposes of Section 469(h)(2).

a. Proposed Regulations. Under the proposed regulations, an interest in an entity shall be treated as an interest in a limited partnership as a limited partner if (i) the entity in which such interest is held is classified as a partnership for Federal income tax purposes under Reg. § 301.7701-3; and (ii) the holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement. See Prop. Reg. § 1.469-5(e)(3)(i). However, see Prop. Reg. §

1.469-2T(f)(2) regarding the treatment of income derived from a "significant participation passive activity".

6. Passive Loss Rules As Applied to Certain Corporations. Personal service corporations and closely-held corporations are also subject to the passive loss rules. For purposes of the passive loss rules, the term "closely-held corporation" means a C corporation of which, at any time during the last half of the tax year, more than 50% of the value of its outstanding stock is owned directly or indirectly, by or for not more than five individuals. Section 469(j)(1). For purposes of the passive loss rules, a taxpayer is a personal service corporation for a tax year only if the following conditions are satisfied: (1) it is a "C" corporation (i.e., a corporation which does not have a Subchapter S election in effect); (2) the principal activity of the corporation during the "testing period" is the performance of personal services; (3) the personal services are substantially performed by employee-owners; and (4) the employee-owners own more than 10% of the fair market value of the corporation's outstanding stock on the last day of the "testing period" for the tax year. Section 469(j)(2). Generally, the "testing period" for a particular tax year is the preceding tax year. Treas. Reg. sec. 1.441-3(c). However, in the case of new corporations, the "testing period" is the period beginning on the first day of the tax year and ending on the earlier of (i) the last day of the tax year or (ii) the last day of the calendar year in which the tax year begins. A person is generally an "employee-owner" of a personal service corporation if (i) he is an employee of the corporation on any day of the "testing period" and (ii) he owns any outstanding stock of the corporation on any day of the "testing period."

a. A personal service corporation or a closely-held corporation will be treated as materially participating in an activity during a tax year only if (i) one or more individuals, each of whom is treated as materially participating in the activity, directly or indirectly hold in the aggregate more than 50% of the value of the corporation's outstanding shares, or (ii) in the case of a closely-held corporation, the corporation meets the requirements of an "active business." A closely-held corporation will be considered an active business for these purposes if (1) during the entire taxable year, the corporation had at least one full-time employee whose services were in the active management of the activity, (2) during the entire taxable year, the corporation had at least three full-time, non-owner employees whose services were directly related to the activity, and (3) the amount of deductions attributable to the activity that are allowable to the taxpayer solely by reason of Section 162 and Section 404 exceed 15% of the gross income of the activity. Section 469(h)(4). The passive loss limitation rules are applied to personal service corporations in the same way in which they are applied to an individual. Closely held corporations (other than personal service corporations) may offset passive losses and credits against either passive income or active income, but not against portfolio income.

7. Passive Loss "Activities". For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is considered separately with respect to each rental property unless the taxpayer elects, by filing a statement with his original income tax return for the tax year, to treat all interests in rental real estate as a single rental real estate activity. Section 469 (c)(7)(A); Reg. § 1.469-9(e)(1).

a. In *Miller v. Commissioner*, the taxpayer successfully qualified as a real estate professional by meeting the 750 hour test relating to his 6 rental properties. T.C. Memo. 2011-219 (September 18, 2011). However, the taxpayer did not make an election under Section 469(c)(7)(A) to treat all of his real estate activities as a single activity. The Tax Court held that the taxpayer only materially participated in 2 of the 6 properties, and the Tax Court disallowed the taxpayer's losses with respect to the other 4 properties to offset non-passive income. See also *Shiekh v. Commissioner*, TC Memo 2010-141 (June 10, 2010) and *Schumann v. Commissioner*, TC Memo 2014-138 (July 14, 2014), in which the Tax Courts held that the taxpayers could not treat their rental activities as one activity because they failed to timely elect to do so.

b. In *Senra v. Commissioner,* the husband and wife taxpayers attempted to group the activities conducted by their C corporation with the leasing activities conducted by a limited liability company (LLC) wholly-owned by the taxpayer-husband. T.C. Memo. 2009-79. The sole activity of the LLC was to own and lease the real property used by the C corporation in the operation of its business. The taxpayers argued that their activities satisfied the facts and circumstances test under Reg. § 1.469-4(c), constituting an appropriate economic unit that could be treated as a single activity to measure gain and loss. The Tax Court concluded that, under Section 469(j)(8), the LLC engaged in rental activities, and because those activities were passive, even if the taxpayer-husband materially participated in the activities, they could not be grouped with the activities of the C corporation. Therefore, the passive losses of the LLC could not offset the ordinary income earned by the taxpayers from their activities with the C corporation.

c. As discussed in more detail below, for purposes of determining whether a taxpayer is considered a "real estate professional", a taxpayer's material participation is considered separately with respect to each rental property unless the taxpayer elects, by filing a statement with his original income tax return for the tax year, to treat all interests in rental real estate as a single rental real estate activity. Section 469 (c)(7)(A); Reg. § 1.469-9(e)(1). Failure to make this election to treat all rental real estate activities as one activity does not affect whether the taxpayer is a real estate professional or application of the passive activity loss real estate professional test. See CCA201427016. Instead, each of the real estate activities will be evaluated individually in order to determine the real estate professional's level of participation.

8. <u>Suspended Passive Losses</u>. A taxpayer's passive activity loss for any one year is the amount by which the taxpayer's aggregate losses from passive activities for the taxable year exceed his aggregate income from all passive activities for such year. No deduction is allowed for a taxpayer's net passive activity losses. A taxpayer may, however, carry forward such excess passive losses ("suspended passive activity losses") to be used against income from passive activities in subsequent years. Suspended passive activity losses retain their character when they are carried forward. Therefore, suspended passive activity losses could be either capital or ordinary depending upon the manner in which the losses arose. If a taxpayer does not use suspended passive activity losses to offset his income from passive activities in subsequent years, such losses cannot be recognized until the taxpayer disposes of his interest in the activity that gave rise to the passive activity loss in a transaction in which all gain or loss is recognized for federal income tax purposes.

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a. CCA 201428808. Assume John buys a principal residence for $700,000 and uses the residence as his principal residence for 2 years before converting the residence into a rental property. Individual John then converts the property to a rental activity that is John's only passive activity for purposes of § 469. During each year that the property is rented, it produces $10,000 net losses that are disallowed as passive losses under Section 469(a). After three years of renting the property, John sells the entire property to an unrelated third party for $800,000, realizing a net gain on the sale of $100,000 (not taking into account the $30,000 suspended passive losses). A's $100,000 of gain from the sale of the property is excluded from A's gross income as provided under Section 121(a) (discussed above). In CCA 201428008, the IRS concluded that the gain from excluded under Section 121(a) would not be offset by the $30,000 of suspended passive losses resulting from John's rental activity. Therefore, the suspended passive losses were available to offset passive income in the future.

9. Substantiation. A taxpayer generally has the burden of proof to establish a factual basis for a claimed deduction. If the IRS disallows a deduction, the taxpayer must prove that the deduction is allowed. *Blomeley v. Commissioner*, 23 T.C.M. 514, 517 (1964). The type of evidence required to meet the taxpayer's burden of proof depends on the particular issue and disputed expense deduction. If a taxpayer fails to offer any evidence that they are entitled to the deduction, the disallowance will be upheld. To support the deduction of a business expense, the taxpayer must demonstrate that a payment was made, the amount of the payment, and the purpose of the payment. See *Jacoby v. Commissioner*, T.C. Memo. 1994-612. This can be established through books and records related to the activity as well as the testimony of the taxpayers and others.

a. Tolin v. Commissioner. Although the regulations allow a taxpayer to prove material participation by "any reasonable means", the IRS and the Tax Court are often skeptical of any records that are not a contemporaneous recording of the time and effort spent by the taxpayer and will reject a post-event recollection or "ballpark guesstimate." Treas. Reg. § 1.469-5T(f)(4); *Moss v. Comm'r*, 135 T.C. 365 (2010). In a recent case, however, the taxpayer was able to satisfy the "500 hour" material participation test by relying on phone records, credit card invoices, and testimony as to the taxpayer's efforts in managing the day-to-day operations of an out-of-state horse ranch, corroborating the taxpayer's narrative summary compiled for trial. See *Tolin v. Comm'r*, T.C. Memo. 2014-182.

i. Phone calls. In analyzing the taxpayer's level of participation, the Tax Court first noted the taxpayer's eagerness in managing the breeding operations of the ranch, going so far as to say the taxpayer "micromanaged the activity". The taxpayer's employees at the ranch testified that the taxpayer spoke to each of them over the phone at least once a day, which was corroborated by the taxpayer's phone records. Promotional and informational calls made to other Louisiana breeders by the taxpayer were corroborated by notations he made in a membership directory of Louisiana horse breeders. The IRS argued there may have been double-reporting of phone call hours where those hours were also reported under other activities, such as placing advertisements, and that it was unreasonable for the taxpayer to claim every call made to Louisiana related to his thoroughbred activities, making the reported hours nothing more than a "guesstimate." However, the Tax Court found the taxpayer's evidence regarding hours spent on the phone to be credible, and that a small amount of double-counting did not diminish that credibility, finding that an estimate of up to 350 hours in one year was reasonable.

ii. Travel to Louisiana. Next, the Tax Court considered the taxpayer's travel to Louisiana. Claims of a long work day travelling to visit various prospective and current customers were corroborated by the testimony of his employees and cell phone records indicating that the taxpayer was awake and making calls early most mornings. Cell phone records also indicated that the calls were placed from various locations, corroborating the taxpayer's testimony regarding travel to various customers. Crucially, the taxpayer travelled to Louisiana without family members, which might suggest a non-business purpose to the travel. Although the Tax Court reduced the amount of hours claimed by the taxpayer, it still found an estimate of up to 250 hours to be reasonable. *Compare* to *Pohoski v. Comm'r*, T.C. Memo. 1998-17, in which the Tax Court "significantly discounted" time claimed by a married couple that took a "working vacation" with their two children to visit rental property in Hawaii.

iii. Promotional Materials and Miscellaneous Administrative Tasks. At trial, the IRS had stipulated as to the "voluminous contents" of promotional packets prepared and mailed by the taxpayer. The Tax Court found that the taxpayer's reparation and mailing of promotional packets and the completion of administrative tasks "easily accounted for" any number of hours the taxpayer was otherwise lacking after considering the telephone calls and travel.

iv. Taxpayer was more than just an Investor. The IRS finally argued that a large portion of the hours relied upon by the taxpayer should not count as material participation because the taxpayer was acting as an investor. The Tax Court rejected this argument due to the taxpayer's direct involvement in the day-to-day operations. As a result, the taxpayer was found to satisfy the material participation requirements.

b. Bartlett v. Commissioner. Although the evidence provided by the taxpayer in *Tolin* withstood scrutiny, taxpayers are still highly advised to keep accurate, contemporary records for any time spent participating in passive activities. In *Bartlett*, the taxpayer attempted to prove material participation in a bull breeding ranches through reliance on credit card statements and two "schedules" created by the taxpayer 2-3 years after the activities in question (in response to an IRS audit). T.C. Memo. 2012-254. Although the court found that the narrative summary provided by the taxpayer at trial was generally credible, there were no contemporaneous records documenting the taxpayer's activities. Because of the number of daily work hours alleged by the taxpayer, the Tax Court expected there to be some sort of supporting documentation, such as notes, to-do lists, phone records, etc. The credit card statements provided no information regarding the number of hours the taxpayer worked on any given day. In fact, the credit card statements discredited the taxpayer's schedules because they showed that the taxpayer was in a different state on days he alleged he was working at the ranch. Also, in at least one instance, the schedules alleged that the taxpayer worked 28 hours on bull breeding activities in a single day. Finally, the Tax Court rejected the taxpayer's argument regarding managerial activities under the "facts and circumstances" test because he paid over $13,000 in "management fees" in each tax year in question. Because the taxpayer failed to prove material participation, the Tax Court upheld the Notice of Deficiency for over $90,000 as well as the 20% accuracy-related penalty resulting from underpayment. This should highlight the need for tax professionals to continue to advise their clients to maintain accurate, contemporary logs and to not rely on records created from memory long after the events in question.

D. Taxation of S-Corporations. With respect to real estate investments, it is important to understand the passive income rules for "converted 'S' Corporations", i.e., corporations that were at one point taxed as regular "C" corporations. If an S corporation has accumulated earnings and profits from its days as a C corporation and more than 25% of an "S" corporation's gross receipts in a current year are from passive sources, such as rent, interest (other than interest from deferred payment sales of inventory to customers in the regular course of business), royalties, dividends, annuities, the S corporation will be taxed on that portion of the passive gross receipts in excess of 25%. Section 1375(a). Section 1362(d)(3) excludes gains from sales or exchanges of stock or securities from the definition of passive investment income. Additionally, a converted "S" corporation which has accumulated earnings and profits must also pass a "passive-income" test and will cease to qualify as an S corporation if, for three (3) consecutive years, 25% or more of the corporation's gross receipts are from passive sources. See Section 1362(d)(3).

1. Example. Shareholders of a C corporation with retained C corporation earnings and profits make a Subchapter S election. Four years later, the shareholders decide to sell the corporation's business. The potential buyers and the shareholders eventually agree on a deal where the buyers will buy all of the assets of the corporation except the building and land where the business is conducted. The potential buyers are not interested in purchasing the real estate but agree, instead, to lease the real estate from the corporation. All cash proceeds from the sale of the business are distributed to the shareholders at closing. Because the corporation is a converted "C" corporation with earnings and profits attributable to its "C" corporation years, the corporation may be subject to Section 1375, which imposes a corporate level tax at the highest corporate tax rate on the corporation's income if (1) the S corporation has accumulated earnings and profits attributable to its existence as a C corporation and (2) more than 25% of the S corporation's gross receipts are passive investment income. Under the facts in this scenario, the only income of the S corporation in the post-closing years consists of rent received from the real estate lease, which is passive income. The situation then becomes more complicated under Section 1362(d)(3), which provides that an S election terminates if an S corporation with accumulated earnings and profits has passive investment income exceeding 25% of gross receipts for three (3) consecutive years. The S election may be unwittingly terminated after three (3) years, in which case the corporation reverts back to its C corporation status, and now the real estate is "trapped" inside the C corporation.

E. Carried Interests.

1. Overview. A partnership (or entity taxed as a partnership) may grant equity interest in the partnership to a service provider for a variety of business reasons. In providing an equity interest to a service provider, a partnership may grant either a capital interest or a profits interest. A capital interest entitles the recipient to an immediate right to a share of the partnership's capital, while a profits interest or "carried interest" gives the recipient a right to share only in the partnership's future profits. A service provider is taxed on compensation received for the performance of service. See Section 61(a)(1). When the service provider is paid in property (rather than cash), complex rules apply to determine the timing and valuation of the service provider's

compensation income. See Section 83. Under Section 83, the value of property transferred by a service-recipient to a service-provider is taxable upon transfer unless the property is both not transferable and subject to a substantial risk of forfeiture. If the property received vests immediately (*i.e.*, is "not subject to a substantial risk of forfeiture"), the service provider recognizes income upon receipt. Reg. § 1.83-1(a)(1). If the property is not vested and not transferable, the service provider would generally recognize income upon vesting. However, the service provider may generally elect to include the net fair market value of the non-vested property in income upon receipt. See Section 83(b). The fair market value of the property is determined without regard to restrictions on the transferability of the interest that may lapse in the future. This "83(b) election" must be made no later than 30 days after the date the property is transferred to the service provider. The election is often desirable if the service provider anticipates that the value of the property received will substantially appreciate between the date of receipt and the date of vesting because it allows the service provider to pay ordinary income tax immediately in order to "lock-in" the ability to pay tax on future appreciation at capital gain rates. In addition to reduced tax rates, a carried interest also benefits from deferral, in that it is not taxed until realized. Deferral generally increases in value with both the length of the deferral period and the taxpayer's marginal tax rate. The partnership is allowed a deduction (subject to the general rules on capitalization) in the amount included by the service partner as compensation. Treas. Reg. sec. 1.82-6(a)(1). A carried interest in a partnership is "property" for purposes of the Section 83(b) rules. Therefore, a service provider who receives an unvested and non-transferable carried interest in a partnership in exchange for services provided to the partnership, and makes an 83(b) election as to the carried interest, is taxed on the fair market value of the carried interest upon receipt, although (if properly structured, the value of that carried interest may be low initially).

2. Case Law. The tax consequences of granting a carried interest in a partnership are not addressed by any specific provisions in the Code and instead are subject to common law interpretations. In *Diamond v. Commissioner*, the mortgage broker taxpayer received a share of a partnership's profits in exchange for arranging financing for the partnership's purchase of real property. 492 F2d 286 (7th Cir. 1974), *aff'g*. 56 T.C. 530 (1971). Three weeks later, the taxpayer sold his carried interest for $40,000; this carried interest was entitled to both capital and profits. The Seventh Circuit affirmed the Tax Court's holding that the receipt of the carried interest in the partnership was a taxable event causing the taxpayer to recognize ordinary income. In *St. John v. U.S.*, the court acknowledged that, at least theoretically, the receipt of a profits only interest in a partnership was a taxable event, and sought to determine the fair market value of the interest the taxpayer received. 84-1 USTC 9158 (C.D. Ill. 1983). The court determined fair market value by looking to the amount the taxpayer would receive upon an immediate liquidation of the partnership, and concluded that this liquidation value was zero on the date of issuance. Thus, the taxpayer was not required to include an amount in income upon receipt of the partnership interest. Similarly, in *Campbell v. Commissioner*, the taxpayer received a profits interest in real estate partnerships that the taxpayer helped form and syndicate. 943 F.2d 815 (8th Cir. 1991). The Eighth Circuit held that the profits interests had no ascertainable fair market value due to its restricted transferability, subordinate rights to cash distributions and return of capital and lack of management participation.

3. Revenue Procedures. The IRS attempted to clarify the tax treatment of profits interests in two revenue procedures. The general approach under Rev. Proc. 93-27, 1993-2 C.B. 343

exempts a service provider from recognizing compensation income upon the receipt of a "profits interest" for the provision of services to or for the benefit of a partnership in a partner capacity [or] in anticipation of being a partner requirements. A profits interest is defined as an interest in the partnership that would not provide the partner with a right to a share of the proceeds if the partnership sold all of its assets for fair market value and immediately liquidated. However, the general rules does not apply if (a) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, (b) within two years of receipt the partner disposes of the profits interest, or (c) the profits interest is a limited partnership interest in a publicly traded partnership. Under Rev. Proc. 2001-43, 2001-2 C.B. 191, a substantially non-vested profits interest will be treated as having been received on the date of grant (rather than upon vesting) if (i) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of the grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with the interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest, (ii) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation or otherwise) for the fair market value of the interest, and (iii) all other requirements of Rev. Prov. 93-27 are met.

a. Example. John forms a partnership to acquire and developed real estate. Jane serves as the manager of the various projects undertaken by the partnership. In exchange for her services to the partnership, Jane is issued a profits interest at the end of Year 1. If Jane voluntarily terminates her employment with the partnership during the next five years, Jane must forfeit the profits interest. Under Rev. Proc. 2001-43, Jane will value the interest and include it in income upon issuance at the end of Year 1. If the profits interest meets the requirements under Rev. Proc. 93-27, no income would be included upon the issuance at the end of Year 1 and the vesting at the end of Year 6 will not be considered a transfer or a taxable event as long as the conditions in both revenue procedures are followed by the partnership and Jane. However, if Jane receives 20% of the profits interest at the end of each of the five years, the provisions of Rev. Proc. 2001-43 will not apply and the interest will be valued and included in income at the end of each of the five years. In this case, an 83(b) election would not be possible because the profits interest would not have been transferred as of the end of Year 1.

4. Compare: Allocations to Unvested Capital Interests. In *Crescent Holdings LLC v. Commissioner*, the Tax Court held that income allocated to a non-vested capital interest partner was improperly allocated to the interest holder, and must be reallocated solely among the vested partners. 141 T.C. No. 15 (12/2/13). The CEO of Crescent Holdings received an un-vested capital interest which would vest at some point in the future as part of his compensation. Despite the CEO's non-vested interest, the partnership allocated him partnership income in 2006 and 2007. The CEO reported the income, $423,611 and $3,608,218, respectively, on his income tax return, yet received no distributions. Prior to his interest vesting the CEO resigned and the partnership filed for bankruptcy. The CEO filed a petition claiming he should not have been allocated the income, as he was not a vested partner. Because the CEO received a capital interest in the partnership and not a profits interest, the Tax Court ruled that the CEO should not have been allocated the income. Under the Section 83 treasury regulations, the transferor of property (here the partnership) is treated as the

owner of the property until it becomes vested in the recipient. Because the CEO did not make an 83(b) election and failed to work for the partnership until his interest had vested, the partnership (the other partners) should be treated as the owner of the unvested partnership interest.

5. Proposed Regulations. In 2005, the IRS released proposed regulations on the tax treatment of partnership interests issued for services. REG-105346-03, 2005-24 IRB 1244, Notice 2005-43, 2005-1 CB 1221. The proposed regulations maintained the general approach of the Revenue Procedures discussed above, in that a service provider may still generally avoid tax on the receipt of a partnership profits interest. However, the regulations contain procedural hurdles to obtaining tax-free treatment, and generally require taxpayers to opt in to tax –free treatment, rather than providing for the default tax-free treatment (i.e., the "Section 83(b) election" discussed above). The proposed regulations clarify that Section 83 applies to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. The proposed regulations also specifically apply only to a transfer by a partnership of an interest in that partnership in connection with the performance of services for that partnership.

a. In addition to the rules regarding Section 83(b) elections, the regulations clarified liquidation value treatment is available only for profits interests that provide the recipient with no right to any immediate share of partnership capital. Thus, even a small capital interest coupled with a profits interest, which may occur as a result of an error in valuation, may taint the availability of the liquidation value method. For example, consider a service provider who receives a 10% share of future profits and a $1,000 share of partnership capital. The price a third party would pay for the interest is $100,000. Under Rev. Proc. 93-27 and Rev. Proc. 2001-43, even this small capital interest may be enough to taint the availability of the liquidation safe harbor method, such that the service provider must include $100,000 as compensation income. In contrast, under the proposed regulations, a taxpayer may elect the liquidation valuation method, and recognize only the $1,000 liquidation value of the interest when received.

6. Application to Real Estate Developments. In the real estate industry, the general partner of a real estate partnership is often the developer of a project. The general partner usually receives a carried interest (also known as a "promoted interest") in the partnership that owns the real estate project, which gives the developer a financial interest in the long-term capital gain of a development. If the property is sold at a profit that exceeds the agreed upon returns to the investors, the developer receives a portion of the profits. This serves to align the interests of the GP with the investors by allowing the GP to share in the "upside" of the real estate venture, and to compensate the GP for the substantial risks taken during development of the project and during the period prior to sale of the property. As we have discussed above, the carried interest can be treated as [long-term] capital gains income taxed at favorable capital gains rates.

7. Reform Proposals. There have been many proposals since 2007 to change the federal income tax treatment of carried interests. They have been included in all of President Obama's budget proposals, and have been the subject of separately introduced bills as well. These bills include the American Jobs Act, the Carried Interest Fairness Act of 2012, all of President Obama's proposed budgets and, most recently, the Tax Reform Act of 2014.

a. President Obama's Proposals. The President's 2015 budget proposal calls for the taxation of a carried interest as ordinary income less compensation from "enterprise value." Specifically, President Obama proposal would provide that a partner's income from holding or disposing of an Investment Services Partnership Interest ("ISPI") would be ordinary income and subject to self-employment tax. This would apply to all ISPI interests (not just interests received for services or otherwise disproportionate to capital) unless a Qualified Capital Interest ("QCI") exception applies.

i. ISPI Defined. An ISPI means any interest in an investment partnership acquired or held by any person in connection with the conduct of a trade or business which primarily involves the managing, acquiring, disposing, arranging financing and advising as to the advisability of investing purchasing or selling any "Specified Assets". An "investment partnership" is any partnership in which, at the end of any calendar quarter after December 31, 2012, (i) substantially all of the partnership assets are Specified Assets, and (ii) more than one-half of the capital of the partnership is contributed by one or more persons in exchange for partnership interests which (in the hands of such persons) constitute property held for the production of income. The term "Specified Asset" means securities, ***real estate held for rental or investment***, interests in partnerships, commodities, cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing. The "production of income" requirement seems to exclude partnerships which conduct operating businesses and partnerships in which more than half the owners are involved in the business. The proposed legislation requires recognition of ordinary income in normally tax-free transfers, such as corporate contributions and mergers where ISPIs are among the assets would be taxable to the extent of the gain inherent in the ISPIs.

ii. QCI Defined. QCIs are generally defined as partnership interests which are received in exchange for the contribution of property (and not in exchange for services). A QCI means the partner's interest in the capital of the partnership which is attributable to: (i) the fair market value of any money or other property contributed to the partnership in exchange for such interest; (ii) any amounts which have been included in gross income under Section 83 with respect to the transfer of such interest; or (iii) the *excess* of any items of income and gain *over* any items of deduction and loss taken into account under Section 702 with respect to such interest. A QCI exception only applies to persons who are not related to other partners in the ISPI and there is no exception for completely pro rata partnerships.

b. Tax Reform Act of 2014. House Ways and Means Committee Chairman Dave Camp from Michigan released his tax reform plan in early 2014. This plan adds a new Section 1061 to the Code, which re-characterizes capital gains from certain partnership interests held in connection with the performance of services as ordinary income. This rule would apply to partnership distributions and dispositions of partnership interests. The provision would apply to a partnership that is engaged in a trade or business conducted on a regular, continuous and substantial basis consisting of: (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses. Note that the provision would not apply to partnerships engaged in a ***real property trade or business.***

i. Re-characterization. The re-characterization formula generally would treat a service partner's applicable share of the invested capital of the partnership as generating ordinary income by multiplying that share by a specified rate of return (the Federal long-term rate plus 10 percentage points). This re-characterization is intended to approximate the compensation earned by the service partner for managing the capital of the partnership. The re-characterization amount would be determined, but not realized, on an annual basis (i.e., it's cumulative) and tracked over time. To the extent a service partner contributes capital to the partnership, the result would be less capital gain being characterized as ordinary income. Any distribution or gain from the sale of a partnership interest (i.e., a realization event) then would be treated as ordinary to the extent of the partner's re-characterization account balance for the tax year, and amounts in excess of the re-characterization account balance would be capital gain. The invested capital of a partnership is, as of any day, the total cumulative value, determined at the time of contribution, of all money and other property contributed to the partnership on or before such day. Partner loans to the partnership and indebtedness entitled to share in the equity of the partnership would qualify as invested capital. If a taxpayer, at any time during a tax year, holds directly or indirectly more than one applicable partnership interest in a single partnership, all interests in a partnership would be aggregated and treated as a single interest. The provision would be effective for tax years beginning after 2014.

ii. Self-Employment Taxes. Unlike prior carried interest tax proposals, while proposed Section 1061 re-characterizes capital gain as ordinary income, it does not treat it is compensation, nor does it specifically subject the income to self-employment tax. However, this may have been viewed as unnecessary, as net investment income is subject to the 3.8 percent Medicare surcharge in any event.

8. Chapter 14 Issues. Careful planning must be considered when an investment involving carried interests includes related parties. Issues under Chapter 14 of the Code may arise to the extent the ownership interests in the profits of a project are not in proportion to contributed capital.

a. Overview. Section 2701 provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest in a family controlled corporation or partnership to a member of the individual's family. A recapitalization or other change in the capital structure of an entity is treated as a transfer of an interest in such entity to which Section 2701 applies if the taxpayer or an applicable family member receives an applicable retained interest in such entity pursuant to such transaction. A transfer includes a recapitalization or other change in the capital structure of an entity, if the transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a “subordinate interest”) and receives property that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest (a “senior interest”). Reg. § 25.2701-3(a)(2)(ii). The amount of the gift is determined under Section 2701 and the accompanying regulations. Subject to certain exceptions, if the transferor has an applicable retained interest, the value of that applicable retained interest is deemed to be zero and the gift tax value of the interest transferred to the transferor’s family member is essentially the value of that interest plus the value of transferor’s applicable retained interest (as determined without regard to any burden on that transferor's applicable retained interest). This special valuation rule is commonly referred to as the "zero valuation rule."

b. Transfers of Carried Interests. Note that because carried interests are truly profits interests and generally do not provide the holder with voting or other rights in the underlying entities, the transfer restrictions generally applicable to partnership interests (i.e., capital interests) typically do not apply to carried interests. Therefore, the holder of a carried interest may be able to transfer the interest for estate planning purposes. The transfer of a carried interest may be subject to the special valuation rules under Section 2701, which can result in unexpected deemed gifts. If a real estate developer transfers its entire carried interest in a partnership to his children (or a trust for his children) and Section 2701 applies, the gift is valued under the subtraction method discussed above, and the interest retained by the developer (e.g., a limited partner interest) is valued at zero for gift tax purposes. This means the developer may be deemed to have made a gift of his entire interest in the partnership (including the capital interest).

c. CCA 201442053. In CCA 201442053, a Mother and her sons formed a limited liability company (the Company). The mother contributed real property and was the sole member to make a capital contribution. Following her contribution, she made gifts of membership interests to her sons and grandchildren. Each member's capital account is credited with the amount of his or her capital contribution. Profits and losses are then allocated to a member's capital account pro rata based on his or her ownership interest. Up to this point, there was no Section 2701 problem. But later, the mother, sons and grandchildren recapitalized the Company. The sons agreed to manage the Company, and the operating agreement was amended to provide that going forward all profit and loss, including all gain or loss attributable to Company's assets, would be allocated equally to the sons. After the recapitalization, Mother's and the grandchildren's sole equity interest in Company was the right to distributions based on their capital account balances as they existed immediately before the recapitalization. When the Company was recapitalized, Mother surrendered her right to participate in future profit and loss, including future gain or loss attributable to Company's assets. Both before and after the recapitalization, she held an applicable retained interest – an equity interest in the Company coupled with a distribution right. Her interest, which carried a right to distributions based upon an existing capital account balance, was senior to the transferred interests, which carried only a right to distributions based on future profit and gain (i.e., a carried interest). Therefore, the recapitalization was a transfer by Mother under Section 2701, and the value of the gift to sons would be determined under Section 2701. Commentators have criticized the IRS's analysis in CCA 201442053 based on the facts stated therein, but practitioners should keep this opinion and the possible application of Section 2701 in mind when structuring the ownership of limited liability companies and partnerships among family members.

F. Surtax Structuring.

1. General. Section 1411, effective January 1, 2013, imposes a tax of 3.8% of the lesser of net investment income or the excess of modified adjusted gross income ("MAGI") over certain applicable threshold amounts. Final regulations were issued under Section 1411 on November 26, 2013. The tax applies to individuals, trusts and estates. Neither nonresident individuals nor charitable trusts are subject to the tax. Section 1411(e). The tax is taken into account

in determining the amount of estimated tax that an individual must pay, and is not deductible in computing an individual's income tax. Section 6654(f).

2. Net Investment Income. The term "net investment income" is the sum of:

a. gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the Medicare tax does not apply);

b. gross income derived from a passive activity or from trading in financial instruments or commodities;

c. net gain (to the extent taken into account in computing taxable income) from the disposition of property other than property held in a trade or business to which the tax does not apply; less

d. the deductions properly allocable to such gross income or net gain.

e. Note that, in determining net investment income, there is no distinction between qualified and ordinary dividends, or between short-term and long-term capital gains. Trade or business income from pass-through entities is excluded from the definition of net investment income only if the taxpayer materially participates under the passive activity loss rules, or if that income is otherwise subject to self-employment tax. Income, gain or loss on working capital is not treated as derived from a trade or business and thus is subject to the tax. Section 1411(c)(3).

3. Exclusions from Net Investment Income. Net investment income does not include:

a. items which are excludable or exempt from income under the Code, including tax exempt interest; gain from the sale of a principal residence (up to $250,000 for a single taxpayer or $500,000 for a married couple); Gain on the sale of Qualified Small Business Stock under Section 1202; or Gain excluded under Section 1031 (like-kind exchanges) or 1033 (involuntary conversions);

b. any income that is subject to self-employment tax.

c. distributions from qualified plans or IRAs.

d. gain from the sale of S corporation or partnership interests to the extent attributable to active assets. Under this rule, this gain is net investment income to the extent that a partner or S corporation shareholder would have net investment income if the entity sold all of its property for fair market value immediately before the stock or partnership interest was sold.

4. Deductions related to Real Estate. Note that, among others, deductions described in Section 62(a)(4) allocable to rents and royalties are taken into account in determining net investment income. Other deductions include net operating losses under Section 172 as well as

deductions described in Section 62(a)(1) allocable to gross income from trades or businesses that are subject to the surtax (passive activities and trading activities); provided that the deductions have not been taken into account in determining self-employment income.

5. Thresholds. For individual taxpayers, the MAGI thresholds are as follows: (a) \$200,000 for single taxpayers, (b) \$250,000 for married taxpayers filing jointly or qualifying widow/ers, and (c) \$125,000 for married taxpayers filing separately. MAGI is equal to (i) the taxpayer's Adjusted gross income (Line 37 from Form 1040, in the case of an individual), plus (ii) the net amount of income excluded under the Section 911(a)(1) foreign earned income exclusion. Note that MAGI may include income that are not treated as net investment income, (such as distributions from a traditional IRA (but not a Roth IRA)) but which cause a taxpayer to pass the applicable threshold and become subject to the surtax on their other investment income.

6. Structuring Considerations. Section 1411(c)(2)(A) states that the surtax applies to trades and businesses if such trade or business is a passive activity with respect to the taxpayer, within the meaning of Section 469. Therefore, a taxpayer who materially participates in a trade or business of a partnership or S corporation may avoid the tax on net investment income, but must still contend with self-employment taxes. Thus, planning for both taxes must consider the exceptions to self-employment tax. See Section II.C for a complete discussion of the passive activity loss rules and applications to various entity structures.

a. Partnerships. In the partnership context, a general partner is subject to self-employment tax on guaranteed payments and on his distributive share of the partnership's trade or business income. Section 1402(a). In contrast, a limited partner is subject to self-employment tax only on guaranteed payments for services. Section 1402(a)(13). Neither a general nor a limited partner is subject to self-employment tax on their share of the partnership's non-trade or business income (such as capital gains, dividends, etc.).

i. In *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, a tax law firm formed as a limited liability partnership (the "LLP") was owned by three individuals and a Subchapter S corporation owned by an employee stock option plan ("ESOP"). 136 T.C. 137 (2011). In 2004, the LLP specially allocated 87.557% of its income (99% of which was derived from legal services) to the S corporation. Because the S corporation was solely owned by the ESOP, it paid no income or self-employment tax with respect to its distributive shares from the LLP. The LLP did not report any of its income as net earnings from self-employment. In 2005, the partnership recapitalized to provide for a managing general partner interest (a "GP interest") and an investing partner interest (an "LP interest"). The three individual partners each took a 1% GP interest and a 32% LP interest, while the S corporation was removed as a partner from the LLP. Allocations were generally limited to a partner's collections and no self-employment tax was paid on allocations to the LP interests. The court disallowed the special allocation to the S corporation in 2004 because, among other things, the LLP did not produce an LLP agreement that permitted the special allocation. With respect to the 2005 tax year, both the IRS and the court accepted the allocations, largely due to the production of an amended LLP agreement supporting the allocations. The court held that each partner was subject to self-employment tax with respect to the distributive shares to the partners

(both the re-determined distributive shares in 2004 and the accepted distributive shares in 2005 from both types of interests.)

(a) The Tax Court's analysis in reaching the holding against the taxpayer is instructive. The court interpreted the legislative history to provide that limited partners of an LLP are akin to passive investors in that they lack management powers and their distributive shares arise as a return on invested capital and constitute investment-type earnings. In *Renkemeyer*, the three individual limited partners had management powers and performed services which generated the partnership's income. Thus, the Tax Court concluded that the three individual limited partners were not the same as limited partners who are mere passive investors of capital. The court's decision can be interpreted to provide that only passive investors may qualify as limited partners exempt from self-employment tax and that owners of a limited partnership are subject to an "all or nothing" approach. Under this approach, the performance of services for a limited partnership will subject the service-providing partner's entire share of partnership income to self-employment tax, regardless of whether that partner has invested capital in the partnership or not. However, the court's all-or-nothing approach could be a referendum on the egregious behavior of the partners in issue in *Renkemeyer*, limiting its application to the facts of the case.

ii. In Chief Counsel Advice 201436049 (May 20, 2014), the IRS held that the members of an LLC (taxed as a partnership) were subject to self-employment tax on their income from the LLC. The LLC served as a management company for various hedge fund partnerships in which the LLC was also a partner. The LLC's primary source of income was fees from providing investment management services. The LLC members reported wage amounts from the management company on Form W-2 and reported health insurance guaranteed payments representing health insurance premium and parking benefits as self-employment income. The IRS concluded that the income earned by the LLC members through the management company was not of an investment nature of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to the limited partner exception. The IRS thus engaged in a substantive evaluation of whether the LLC members were acting as limited partners. Looking in part to *Renkemeyer*, the IRS noted that the partners performed extensive investment and operational management services for the partnership in their capacities as partners.

b. <u>Member-Managed LLC</u>. If the taxpayer owns a trade or business structured as a limited liability company which has elected to be taxed as a Subchapter S corporation by filing IRS forms 8832 (check the box election) and 2553 (S corporation election), it may be possible to avoid the Section 1411 tax while also avoiding self-employment tax. It is generally beneficial to be taxed as an S corporation because of the greater certainty that distributions to its members will not be subject to the employment tax. However, this benefit may not be available, particularly if the LLC does not meet the requirements to be an S corporation, or it may not be desirable for other reasons. A Texas LLC must be organized to be managed either by its members (i.e., its owners) or its manager(s) (which are akin to corporate directors). Structuring the business as a member-managed LLC, as opposed to manager-managed LLC, is important. Additionally, it may be helpful to not appoint officers so it is clear that the taxpayers are acing in their capacities as members.

c. “Close” Corporations. Following the logic of the preceding paragraph, it may also be beneficial to structure the business as a close corporation, taxable as an S corporation for Federal tax purposes. A close corporation is a for-profit corporation or professional corporation that states in its certificate of formation that "this corporation is a close corporation," or similar provision. If the corporation has already filed its initial certificate of formation it my file a certificate of amendment to add the statement. The benefit of a close corporation is that it may be managed according to a shareholders' agreement by the shareholders instead of by a board of directors or bylaws. *See, e.g.,* Texas BOC §§ 21.701 et seq. Management by the shareholders allows the shareholders to directly materially participate in the corporation business as shareholders, rather than as directors or officers. Close corporations are also subject to a few other statutory requirements. Also, to avoid the Service’s rationale in TAM 201317010, officers should not be appointed for the corporation.

d. Regrouping of Passive Activities. Taxpayers who or which own interests in a number of passive activities should also consider the way they group these activities for purposes of the passive activity loss rules. See Section II.C above. A taxpayer may treat one or more trade or business activities or rental activities as a single activity (i.e., group them together) if based on all the relevant facts and circumstances the activities are an appropriate economic unit for measuring gain or loss for PAL purposes. Reg. §§ 1.469-4(c)(1), (2). A number of special "grouping" rules apply. For example, a rental activity can't be grouped with a trade or business activity unless the activities being grouped together are an appropriate economic unit and a number of additional tests are met. Real property rentals and personal property rentals (other than personal property rentals provided in connection with the real property, or vice versa) cannot be grouped together. A taxpayer who has grouped activities cannot regroup them in later years merely because he wants to change the grouping, but if a material change occurs that makes the original grouping clearly inappropriate, he must regroup the activities. Reg. §§ 1.469-4(e), (f).

i. Proposed regulations issued late last year provide a regrouping "fresh start" allowing qualifying taxpayers to regroup their activities for any tax year that begins during 2013 if Section 1411 would apply to the taxpayer without regard to the effect of regrouping. A taxpayer may only regroup activities once, and any regrouping will apply to the tax year for which the regrouping is done and all later years. Prop. Reg. § 1.469-11(b)(3)(iv). The regrouping must comply with the disclosure requirements under Rev. Proc. 2010-13, 2010-4 IRB 329 and Reg. § 1.469-4(e).

e. Use of Installment Sale. The gains from a sale are generally taxable in the year of sale. However, by using installment sale treatment so that part or all of the proceeds from the sale are payable next year or later, a seller will only be subject to tax on the payments that are actually received during the year.

i. Example. In December 2014, John and Jane Smith will close on the sale of a piece of investment land that will yield a profit of $100,000. Before factoring in the sale, (a) their 2014 MAGI will be $240,000, consisting of $15,000 NII, and $225,000 of salary and other earned income; and (b) their 2015 MAGI is expected to be $170,000, consisting of $5,000 NII and $165,000 of salary and other earned income. If they sell the land for cash, they will pay a surtax of $3,420. That's 3.8% of the lesser of: (1) $115,000 NII ($100,000 land sale profit + $15,000 other NII); or (b) the $90,000 excess of $340,000 MAGI ($100,000 land sale profit + $15,000 of other NII and $225,000 of salary and other earnings) over $250,000, the threshold amount for married couples filing jointly. On their 2013 return, they also will pay regular capital gains tax on the entire profit. However, if the buyer pays 10% of the price of the land in 2014 as a down payment and pays the other 90% in January of 2015 (or later), the Smiths' can use the installment sale method. This way, for 2014, they will pay no surtax. That's because their 2014 MAGI won't exceed the $250,000 threshold amount ($10,000 land sale profit recognized + $15,000 other NII + $225,000 of salary and other earnings = $250,000). Their surtax for 2015 will be only $380. That's 3.8% of the lesser of: (1) $95,000 NII ($90,000 land sale profit recognized in 2014 + $5,000 other NII), or (b) the $10,000 excess of $260,000 MAGI ($90,000 land sale profit recognized in 2014 + $5,000 other NII + $165,000 in salary and other earnings) over the $250,000 threshold. This way, they also will pay 2013 capital gains tax on only $10,000 of gain, deferring tax on the other $90,000 until 2014.

G. S Corporation Issues.

1. Limitations on Losses. The aggregate amount of losses and deductions taken into account by an S corporation shareholder for any taxable year cannot exceed the sum of (a) the adjusted basis of the shareholder's stock in the corporation; and (b) the adjusted basis of any indebtedness of the corporation to the shareholder. Reg. § 1.1366-2(a)(2)(i).

a. Stock Basis. A shareholder's initial basis in his S corporation stock is the price paid in exchange for the stock. § 1012. To the extent the S corporation transfers property to a shareholder, as compensation for services, for an amount less than its fair market value, then the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is treated as compensation to the shareholder and shall be included in the gross income of the shareholder. Reg. § 1.61-2(d)(2). The shareholder's basis may be increased by the amount of such difference included in gross income or the adjusted basis of property contributed to the corporation in a Section 351 transaction. *See also* Section 358(a)(1) regarding any "boot" received. The shareholder's stock basis is increased by his share of the S corporation's income, whether or not separately stated, and the excess of depletion deductions over the basis of the depletable property. Section 1367(a)(1). The shareholder's stock basis is decreased by his pro rata share of the S corporation's loss or deductions (whether or not separately stated), distributions not includable in the shareholder's income, items that are neither deductible nor chargeable to shareholder, and depletion (up to the basis of the depletable property), but not below zero. Section 1367(a)(2).

b. S Corporation Debt Basis. A shareholder's basis in the indebtedness of the S corporation is the amount loaned by the shareholder to the corporation. The final regulations under Section 1366 issued in July 2014 provide that S corporation shareholders increase their basis of indebtedness of the S corporation to the shareholder only if the indebtedness is *bona fid*e, which is determined under general Federal tax principles and depends upon all of the facts and circumstances. Reg. § 1.1366-2(a)(2)(i). However, the regulations do not create an objective standard for what constitutes bona fide indebtedness.

i. Actual Economic Outlay. Prior to the final regulations, the courts developed the "actual economic outlay" standard for determining whether S corporation shareholders were entitled to increase their basis in the S corporation. The "actual economic outlay" test required that the indebtedness must leave the shareholder "poorer in a material sense". See, e.g., *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), *aff'g*, T.C. Memo. 2002-172; *Perry v. Commissioner*, 54 T.C. 1293 (1970); *Underwood v. Commissioner*, 63 T.C. 468 (1975), *aff'd* 535 F.2d 309 (5th Cir. 1976). In *Maguire v. Commissioner*, the Court determined that a distribution of an S corporation's accounts receivable to its shareholders, followed by their contribution of the receivables to a related S corporation, did increase the shareholders' basis in the second S corporation's stock, allowing them to deduct its losses. TC Memo 2012-160 (2012). The Service unsuccessfully argued that the shareholders did not make a real economic outlay in the transaction.

ii. Example. John is the sole shareholder of S, an S corporation. S receives a loan from John. Whether the loan from John to S constitutes bona fide indebtedness from S to John is determined under general Federal tax principles and depends upon all of the facts and circumstances. If the loan constitutes bona fide indebtedness from S to John, John's loan to S increases John's basis of indebtedness in S. The result is the same if John makes a loan to S through an entity that is disregarded as an entity separate from John. Reg. § 1.1366-2(a)(2)(iii)(Ex. 1).

iii. Example. John is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to John. John then loaned $200,000 to S2. Whether the loan from John to S2 constitutes *bona fide* indebtedness owed by S2 to John is determined under general federal tax principles and depends upon all of the facts and circumstances. If John's loan to S2 constitutes *bona fide* indebtedness owed by S2 to John, John's back-to-back loan increases John's basis of indebtedness in S2. Reg. § 1.1366-2(a)(2)(iii)(Ex. 2).

iv. Example. John is the sole shareholder of two S corporations, S1 and S2. In May 2014, S1 made a loan to S2. In November 2014, S1 assigned its creditor position in the note owed by S2 to John, by making a distribution to John of that note. Under local law, after S1 distributed the note to John, S2 was relieved of its liability to S1 and was directly liable to John. Whether S2 is indebted to John rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. If the note constitutes bona fide indebtedness from S2 to John, the note increases John's basis of indebtedness in S2. Reg. § 1.1366-2(a)(2)(iii)(Ex. 3).

c. Shareholder Guarantees. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment. Reg. § 1.1366-2(a)(2)(ii). For example, Rev. Rul. 70-50 and Rev. Rul. 71-288 each provide that, when the guarantor shareholders actually paid the corporate debt, the original debt shifted from the original creditor to the shareholder, and thus, the corporation was in fact indebted to the shareholders. Further, in the event a shareholder makes a payment on a guaranty, the shareholder will receive a debt basis for the guaranty payment in the year the payment is made, not in the year in which the guaranty was executed. Rev. Rul. 71-288.

i. Example. John is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required John's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and John made payments directly to Bank from John's personal funds until the loan obligation was satisfied. For each payment John made on the note, John obtains basis in the indebtedness. Thus, John's basis of indebtedness is increased during 2015 to the extent of John's payments to Bank pursuant to the guaranty agreement. Reg. § 1.1366-2(a)(2)(iii)(Ex. 4).

d. Indebtedness Planning. The final regulations focus on related party lending and whether these transactions create a bona fide indebtedness. However, there are other planning techniques that have been used by S corporation shareholders, with mixed success, to increase their stock basis.

i. Third Party Back-to-Back Loans. In the case of back-to-back loans, the shareholder does not make a loan to the corporation using funds that he currently has on hand. Rather, the shareholder first obtains a loan from a third party, typically a bank. Then, the shareholder uses the borrowed funds to make a loan to the S corporation. *See*, e.g., *Harris v. United States*, 902 F.2d 439, 443 (5th Cir. 1990); *Estate of Leavitt v. Commissioner*, 875 F.2d 420, 422–23 (4th Cir. 1989). Typically, the shareholder will pledge his S corporation stock to secure the loan along with a pledge of the security interest the corporation granted the shareholder in the corporation's assets. In many cases, the back-to-back loan is made pursuant to a restructuring of an indebtedness currently incurred by the corporation. In this case, the shareholder may borrow funds from the original lender or from another lender. The shareholder then loans the funds to the corporation, which may use the funds to pay off its original corporate indebtedness. See also *Hitchins v. Commissioner.*, 103 TC 711 (1994); *Bhatia v. Commissioner.*, TC Memo 1996-429.

(a) Miller. In *Miller v. Commissioner*, the Tax Court allowed a shareholder to increase his basis in his S corporation stock where a third-party loan was restructured as a loan by the original lender to the shareholder followed by a shareholder loan to the corporation. T.C. Memo 2006-125. The S corporation previously owed money to a third party bank, which was guaranteed by the shareholder. In the restructuring, the corporation executed a loan agreement and a security agreement with the shareholder. The shareholder, in turn, assigned his rights in the security agreement to the third-party lender, to whom the shareholder granted an additional security interest in his personal assets. In allowing the taxpayer's increase in basis, the Tax Court relied heavily on the presence of a third-party lender in the transaction.

(b) Ruckriegel. In *Ruckriegel v Commissioner*, the taxpayers were equal shareholders in an S corporation, and equal partners in a partnership. T.C. Memo 2006-78. The partnership transferred funds to the taxpayers, which the taxpayers lent on to the S corporation. The Tax Court accepted this first loan as a valid back-to-back loan that generated basis in the S corporation. The partnership also transferred funds directly to the S corporation, which the taxpayers argued was substantively a loan from the taxpayers themselves. While the Tax Court did not reject the argument that the direct transfers from the partnership *could* be treated as shareholder loans, the court found that, under the particular facts of the case, the partnership was not a mere "incorporated pocketbook" of the taxpayers, and that payments from the partnership could not be treated as made by the taxpayers themselves.

ii. Related Party Circular Loans. Circular loans have been the source of many published opinions, and usually do not result in a favorable outcome for the shareholder. See *Perry v. Commissioner*, 54 T.C. 1293 (1970); *Underwood v. Commissioner*, 63 T.C. 468 (1975), *aff'd* 535 F.2d 309 (5th Cir. 1976); *Kaplan v. Comm'r.*, TC Memo 2005-218; TAM 200619021; *Kerzner v. Comm'r.*, TC Memo 2009-76. In the case of a circular related party loan, the shareholder first obtains a loan from a related party. Next, the shareholder makes a loan to the S corporation. Finally, the S corporation returns the borrowed funds to the original lender or another related party, for example, in the form of rent payments. The case law has historically focused on whether there has been an "actual economic outlay" in disallowing the circular loan. Query whether this will change under the new "bona fide indebtedness" test under the final regulations?

iii. Planning Tips. Although no approach in this field is perfect, taxpayers can take concrete actions to help sustain their basis in an S corporation.

(a) First, taxpayers may consider a holding company structure to hold multiple business ventures. For example, the taxpayer may form a holding company that owns interests in two subsidiaries. The taxpayer may then make any loans to the holding company, rather than to the operating subsidiaries. If the loan is a back-to-back loan, the taxpayer may seek to grant a security interest only in the assets of the operating company that will use the funds.

(b) Second, if the taxpayer has access to funds via a related entity, the shareholder should resist the temptation to make a direct transfer of funds from a related entity to the S corporation. The taxpayer's advisors must be proactive on this point. It is much better for a related entity to make a distribution to the shareholder and for the shareholder to then make a capital contribution to the S corporation.

(c) Third, if the taxpayer decides to fund the S corporation via a loan, the shareholder should, to the extent possible, borrow funds from a third party lender. Moreover, all formalities of the loan should be observed. Among other things, the indebtedness should be evidenced by written notes, and the corporation should make the stated payments of interest and principal.

e. Basis and Passive Activity Loss Limitations. Passive activity losses can affect S corporation shareholder basis even if the shareholders are unable to actually take the losses. In *Barns v. Commissioner*, husband and wife S corporation shareholders claimed a deduction of $279,289.00 for their pro rata share of the S corporation's losses for the applicable tax year. (CA DC 04/05/2013) 111 AFTR 2nd 2013-611. The IRS disallowed the loss, claiming that their basis in the S corporation stock was only $153,283.00. The IRS included passive activity losses from the S corporation in calculating a reduction in the shareholder's basis even though the shareholders were not able to deduct the losses due to passive activity loss limitations. The Court of Appeals from the

District of Columbia held that Section 1367(a)(2) requires an S corporation shareholder to reduce basis by any losses that he is required to take into account under Section 1366(a)(1), even if *the shareholder does not actually claim the losses on his return.* Accordingly, the shareholder's losses were disallowed.

f. Comparison to Partnership Basis Rules. Under Subchapter K, partners of a partnership are deemed to have made a contribution to a partnership when the partners' shares of partnership liabilities increase. See Section 752. Under Section 722, any such increase in partners' shares of partnership liabilities will result in an increase in each partner's basis in the partnership. This increase in a partner's basis in the partnership creates opportunities for partners that are not available to shareholders of S corporations. However, even in the partnership context, the notes must be actually funded in order to create basis. See *VisionMonitor Software LLC v. Comm'r*, TC Memo 2014-182,

i. Example. A, B and C are equal partners in ABC Partnership. A, B and C each have a basis of $30,000 in their interests in ABC Partnership. ABC Partnership owns a single building worth $200,000 with a basis of $90,000. The building is not subject to debt. A, B and C decide to cause the partnership to borrow $150,000 and use the building as collateral for the loan. The liability of the partnership will be allocated equally among A, B and C. After borrowing the funds, A, B and C decide to distribute the $150,000 loan proceeds equally among the partners. Thus, A, B and C each receive $50,000 of cash on the distribution. Because the $150,000 was allocated equally among A, B and C, the outside basis of each partner is increased from $30,000 to $80,000. Thus, the distribution of the $50,000 cash from the partnership to each partner does not result in gain to any of the partners since the cash distribution did not exceed the partners' respective "outside" basis in their partnership interests (as increased by their respective share of the $150,000 in debt that increased the basis). If A, B and C were instead equal shareholders in ABC Corporation, an S corporation, the corporation's borrowing of $150,000 of debt would not increase any of the shareholder's basis in their ABC stock. Thus, a subsequent distribution of the loan proceeds would create taxable gain to each of the shareholders, as the $50,000 distribution would exceed the shareholders' basis in their stock by $20,000. Each shareholder would recognize $20,000 of income on the distribution.

2. No Special Allocations. Subchapter K provides that partners in a partnership may agree to specially allocate items of income, gain, loss, deduction or credit to particular partners, so long as the allocation has substantial economic effect. *See* Section 704(b). Under Subchapter S, an S corporation's items of income, loss, deduction and credit are allocated to shareholders in proportion to their common stock ownership and, more specifically, unless elected otherwise, on a per-share, per-day of the taxable year basis. *See* Section 1366(a)(1); Section 1377(a)(1). *See also* Section 1362(e)(2), regarding a similar per share, per day allocation during a termination year.

a. Example. A and B would like to go into business together. A is the "money" guy and will contribute $900 to the new venture. B is the "sweat equity" guy and will contribute $100 and his time and skill set to the new venture. If A and B form AB, Ltd., Subchapter K and Section 704(b), with some limits, will allow them to allocate items of income and loss among the partners in accordance with the partnership agreement. If A and B form AB, Inc., in which A owns 90% of the stock and B owns 10% of the stock, Subchapter S (and Subchapter C) require A and B to allocate income and losses in accordance with their ownership percentages. A and B will have to figure out compensation schemes different from the ownership structure in order to compensate B for his contribution to the profits of the company. In fact, owners in this situation often times do not make the sweat equity partner an actual owner of the company but instead compensate him through an employment arrangement which is dependent on the profits of the company. However, in using this approach, there could be some risk, depending upon the reasonableness of the sweat equity partner's compensation, that this employment arrangement is regarded as a second class of stock (depending upon the terms of the arrangement).

3. Converted C Corporations. Additional challenges can also arise with respect to S corporations which have a history of previously being a C corporation ("Converted C corporation"). For the past 15 years or so, S corporations have been one of the fastest growing business entity types, with conversions from C corporations to S corporations contributing to this growth. Taxpayers who have converted their incorporated real estate business activities from C corporations to S corporations should be aware of specific issues that arise in Converted C corporations. Three such issues are particularly noteworthy: (i) the corporate level tax on built-in gains; (ii) the corporate level tax on excess passive investment income; and (iii) the potential loss of S corporation status for having too much passive income.

a. Corporate Tax on Built-In Gains. Section 1374 imposes a tax on a Converted C corporation's built-in gains. In general terms, built-in-gain is the amount by which the fair market value of the assets of the Converted C corporation upon the date of the S election exceeds the aggregate adjusted bases of the assets. Section 1374(d)(1). The tax is imposed if: (i) the S-election was made after 1986; (ii) the Converted C corporation has a net recognized built-in gain within the recognition period; and (iii) the net recognized built-in gain for the tax year does not exceed the net unrealized built-in gain minus the net recognized built-in gain for prior years in the recognition period, to the extent that such gains were subject to tax. Section 1374(c).

i. Pre-2009 and Post-2014 Ten Year Recognition Period. For an S corporation's tax years other than 2009 through 2014, the recognition period is the 10-year period beginning on the first day on which the corporation is taxed as an S corporation. Section 1374(d)(7)(A).

ii. 2009 and 2010 Seven Year Recognition Period. For tax years beginning in 2009 and 2010, no tax is imposed on the net-built in gain recognized in either of those years is the seventh tax year in the 10-year period preceding that tax year. Section 1374(d)(7)(B).

iii. 2011-2014 Five Year Recognition Period. The Small Business Jobs Act of 2010 temporarily shortened the seven-year recognition period to five years, for taxable years beginning in 2011. The American Taxpayer Relief Act of 2012 extended the temporary five-year recognition period for tax years beginning in 2012 and 2013. Section 1374(d)(7)(C). The Tax Increase Prevention Act of 2014 extended the temporary five-year recognition period for tax years beginning in 2014.

b. Corporate Tax on Excess Passive Investment Income. Section 1375 provides that, if an S corporation has (i) accumulated C corporation earnings and profits at the close of such taxable year and (ii) gross receipts more than 25% of which are passive investment income, then a tax is imposed on the income of such corporation for the taxable year. The tax is computed by multiplying the corporation's excess net passive income by the highest rate of tax specified in Section 11(b). However, in order to be subject to the tax on excess passive investment income, an S corporation must have taxable income. Section 1375(b)(1)(B). For this purpose, taxable income is determined generally as if the corporation were a C corporation, except no deduction is allowable under Section 172 for net operating loss carryovers or under Sections 241-250 (other than for organizational expenses authorized under Section 248).

i. "Passive Investment Income". Except as otherwise provided in Section 1362(d)(3)(C), Section 1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, dividends, interest, annuities, and some rents. "Rents" generally means amounts received for the use (or right to use) property of the S corporation. Reg. § 1.1362-2(c)(5)(ii)(B).

ii. Active Business Exception. However, "rent" does not include rents derived in the active trade or business of renting property. Rents received by an S corporation are derived in the active trade or business of renting property only if, based on all the facts and circumstances, the S corporation provides significant services or incurs substantial costs in the rental business. Reg. § 1.1362-2(c)(5)(ii)(B)(2). Whether significant services are performed or substantial costs are incurred is based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation). For example, a hotel or assisted living facility are both considered an active business whose rental income is exempt from this rule.

iii. Computing the Tax. A corporation's "excess net passive income" (i.e., the amount on which tax is imposed) is a portion of the corporation's net passive income for the taxable year, multiplied by (i) Passive Investment Income in excess of 25% of gross receipts, over (ii) total Passive Investment Income. "Net passive income" is the excess of the corporation's gross receipts from passive investment income over its allowable deductions directly connected with producing that income. Section 1375(b)(2). Deductions are considered to be directly connected with the production of passive income if they have a proximate and primary relationship to the income. Treas. Reg. § 1.13751(b)(3)(i). Expenses, depreciation, and similar items *solely* attributable to the production of passive investment income are considered to have a proximate and primary relationship with such income. For purposes of the excess passive income rules, the term "gross receipts" refers to the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Treas. Reg. § 1.1362-2(c)(4)(i). Special rules apply for sales of capital assets, stock and securities. *See* Treas. Reg. § 1.1362-2(c)(4)(ii).

iv. Planning Considerations. The additional taxes on excess passive investment income can be reduced or eliminated by using one (or all) of the following planning strategies:

(a) Eliminating its earnings and profits by making dividends prior to S corporation conversion, by electing to treat actual distributions as dividends bypassing the accumulated adjustments account ("AAA"), or by making a deemed distribution election. Currently, many dividends are taxable at a maximum 23.8% effective bracket (inclusive of federal income tax and the surtax).

(b) Disposing of assets that generate passive income.

(c) Acquiring assets that generate active gross receipts, thereby reducing the passive investment income under the 25% threshold, such as interests in "master limited partnerships" which generate a large ratio of gross receipts to net income (e.g., pipelines, oil and gas drilling companies or amusement parks) so the gross receipts from passive investment income will fall under 25% of total gross receipts.

c. Termination of S Corporation Status for Passive Receipts. Section 1362(d)(3)(A)(i) provides that an S-election terminates whenever it (i) has accumulated C corporation earnings and profits at the close of each of *3 consecutive taxable years* and (ii) more than 25% of its gross receipts in each of those 3 years are from Passive Investment Income (discussed above). Under Section 1362, the S election terminates even if the S corporation is not liable for tax on excess passive investment income during this 3-year period. Thus, termination occurs even (i) if the S corporation does not have taxable income during the three-year period (and thus is not subject to Section 1375 tax because of the taxable income limitation) or (ii) if the deductions directly connected with its passive investment income reduce the S corporation's net passive investment income to zero. The same planning considerations are available to avoid a Section 1362 termination as are available to avoid Section 1375 (as discussed in II. G. 3. b. iv. above).

III. INDIVIDUAL REAL ESTATE INVESTORS

A. Sale of Principal Residence.

1. Exclusion of Gain. Under Section 121(a), a taxpayer may exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two (2) years during the five (5) year period ending on the date of the sale or exchange. Section 121(b)(3) allows a taxpayer to apply the maximum exclusion to only one (1) sale or exchange during the two (2) year period ending on the date of the sale or exchange. Note that there have been proposals to increase the personal residence requirement to 5 of the past 8 years in order to limit the application of the exclusion.

a. Example. John owns two homes, one in Texas and one in Colorado. During 2012 and 2013, John lives in the Texas home for 8 months (September-April) and in the Colorado home (May-August) for 4 months. In the absence of facts and circumstances indicating otherwise, the Texas home is John's "primary residence" and he would be eligible to exclude the gain from the sale of the Texas home but not of the Colorado home in 2013.

2. Debt in Excess of FMV. Most homeowners and practitioners are used to an ever-increasing housing market, which generally produces gain on the sale of a principal residence. However, over the past 7 years, many homeowners have worried about the consequences of selling their principal residence for a loss and not being able to pay off the remaining mortgage. To the extent the lender discharged the unpaid balance of a recourse mortgage, the homeowner would have to report cancellation of debt income in the amount of the discharge. In 2007, Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007 which excludes from gross income up to $2 million (for married taxpayers) of cancellation of debt income related to the discharge of indebtedness on a taxpayer's principal residence. Section 108(a)(1)(E). To qualify, the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and be secured by that residence. Refinanced debt proceeds used for the purpose of substantially improving the principal residence also qualify for the exclusion, although proceeds of refinanced debt used for other purposes (e.g., to pay off credit card debt) do not qualify for the exclusion. Debt forgiven on second homes, rental property or business property does not qualify. However, this provision expired on December 31, 2013 and, without further action by Congress, does not apply to debt discharged on or after January 1, 2104.

a. Example. John bought a home in 2007 for $50,000 down plus a $400,000 recourse mortgage so that John's basis in the home is $450,000. The home is his principal residence until 2013, when the outstanding mortgage is $350,000 and he sells it for $250,000. The lender accepts the $250,000 in full satisfaction of the mortgage. John realized a loss from the sale equal to $200,000 ($250,000 amount realized minus $450,000 adjusted basis). John is unable to report the loss on his tax return. John also has $100,000 of reportable COD income—the difference between the cash received in the sale ($250,000) and the outstanding mortgage on the property at the time of the sale ($350,000), which the lender forgave. Under Section 108(a)(1)(E), the $100,000 of COD income is excluded from John's gross income.

b. Example. Same facts as in the example above, except that John sells his house in 2014 (rather than 2013). Section 108(a)(1)(E) is no longer in effect and John must include the $100,000 of COD income in his gross income for 2014.

B. Mortgage Interest Deduction. Interest paid with respect to a mortgage on real estate is deductible interest on acquisition indebtedness under Section 163(a). Acquisition indebtedness is indebtedness incurred to buy, build, or substantially improve an individual's qualified residence. Taxpayers who itemize their deductions can deduct their mortgage interest on up to $1 million ($500,000 for a married individual filing separately) of qualifying acquisition indebtedness on a qualified principal residence and, if applicable, a secondary residence as well. Itemizing taxpayers can also deduct interest on up to $100,000 ($50,000 for a married individual filing separately) of home equity indebtedness, which is debt (other than acquisition indebtedness) secured by a taxpayer's qualified residence, to the extent the aggregate amount of the debt doesn't exceed the fair market value of the personal residence, as reduced by the amount of acquisition indebtedness. Section 163(h)(3)(C)(i). Unlike acquisition debt, home equity indebtedness generally may be used for any purpose without affecting interest deductibility.

1. Mortgage Insurance Premiums. Under the 2012 Taxpayer Relief Act, Mortgage insurance premiums paid or accrued before December 31, 2013 for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer shall be treated for purposes of this section as interest which is qualified residence interest. Section 163(h)(3)(E)(i). The deduction amount shall be reduced (but not below zero) by 10 percent of such amount for each $1,000 ($500 in the case of a married individual filing a separate return) (or fraction thereof) that the taxpayer's adjusted gross income for the taxable year exceeds $100,000 ($50,000 in the case of a married individual filing a separate return). Section 163(h)(3)(E)(ii).

2. Substantiation. As courts love to say, "Deductions are a matter of legislative grace, and taxpayers must prove they are entitled to the deductions claimed… Taxpayers are required to maintain records sufficient to establish the amounts of allowable deductions and to enable the Commissioner to determine the correct tax liability." *Weatherly v. Commissioner*, 102 T.C.M. (CCH) 199, 2011 WL 3794241 (2011). The dispute in *Pesky v. United States* was not whether the taxpayer was entitled to deduct their mortgage interest and the other miscellaneous expenses, but rather whether the taxpayers submitted the right documentation, and in the right form, to substantiate the claimed deductions. 112 AFTR 2d 2013-5232 (07/08/2013). The court denied the government's motion for summary judgment on the issue, finding that there were fact issues as to whether the documentation provided by the taxpayers was sufficient to substantiate the claimed deductions.

3. Phantom Second Home. In *Rose v. Commissioner,* the Tax Court held that a couple could deduct qualified residence interest on a mortgage for a vacation home which was never built. T.C. Opinion 2011-117 (October 4, 2011). In January of 2006, Thomas and Cheryl Rose paid $1,575,000 for beachfront property in Fort Myers Beach, including a $1,260,000 loan to purchase the property. The Roses were unable to obtain a construction permit until February 11, 2008, at which time they were unable to secure construction financing to build a residence on the property. In June 2009, the Roses sold the property for $750,000, suffering an $825,000 loss. The Roses deducted $87,016 and $82,201 in home mortgage interest for 2006 and 2007, respectively. The IRS denied the deductions on the ground that the interest wasn't qualified residence interest. The Tax Court disagreed and allowed the deductions on what it considered a vacation residence to be "under construction" for 2006 and 2007, based on the demolition by the seller of the previous residence and the significant work the Roses performed to get a construction permit. The Tax Court also disagreed with the IRS's contention that the Roses failed to satisfy the requirement that the property must become a qualified residence by selling the property in 2009 before completion of an occupancy-ready residence. In evaluating each tax year on its own, the court stated it was impossible to know if the residence would become ready for occupancy.

4. $1.1 Million Indebtedness Limit. The taxpayers in *Michael Hume et al. v. Commissioner* acquired a home in San Clemente, California as their personal residence in June 2004. TC Memo 2014-135 (July 17, 2014). In August 2005, the taxpayers purchased another single-family home (the "Cazador House"), which was originally built for Oscar nominee Ann Harding (she was nominated for best actress in 1931 for *Holiday*). They taxpayers paid $1,460,000 for the Cazador House, which was paid for in part with a $1 million mortgage. The taxpayers purchased the Cazador House with the intent of renting it out for weekly vacations and for events. However, they did not

realize the amount of work or the repair cost that was needed to make the Cazador House suitable for potential renters. During 2008 and 2009, Taxpayers did not rent nor did they advertise the Cazador House, although they also did not attempt to sell it. The couple refinanced the Cazador House multiple times, including obtaining a $400,000 home equity loan. During 2008 and 2009, after their divorce, the husband lived at the Cazador House when he was not traveling for work. The Taxpayers never completed the renovations before they sold the property on November 16, 2012. The Tax Court has held that the taxpayers (long-since divorced) could not deduct mortgage interest as a business expense on the Cazador House because they never started a rental business and the ex-husband resided in the property. However, the Court did allow interest on $1.1 million of the debt to be deducted as qualified residence interest.

5. Use of Acquisition Proceeds. In *Ellington v. Commissioner*, the taxpayers borrowed over $1.5 million from Merrill Lynch to purchase a residence. T.C. Memo. 2011-193 (August 11, 2011). The loan was secured by the residence and nearly 9,000 shares of Intel stock worth approximately $650,000. The taxpayers later refinanced the Merrill Lynch loan with another lender, and the refinanced loan was secured only by the residence. Because of the $1 million ceiling on the qualified residence interest deduction, the taxpayers attempted to deduct a portion of the interest on the Merrill Lynch loan as investment interest, arguing that a portion of the interest was allocable to the Intel stock because the loan was partly secured by the Intel stock. The Tax Court rejected the argument, applying the tracing rules to conclude that the entire loan was attributable to the purchase of the residence. *See* Reg. § 1.163-8T(c)(1). Under the regulations, debt and interest are allocated to expenditures according to the use of the debt proceeds, and the Merrill Lynch proceeds had been used by the sellers to purchase the residence. In holding for the IRS, the court cited the example in the regulations which provides that a taxpayer who finances the purchase of a personal-use automobile with a loan secured by corporate stock held for investment incurs personal interest expense rather than an investment interest expense. See Reg. § 1.163-8T(c)(1).

6. Pease Limitation on Itemized Deductions. Under the 2012 Taxpayer Relief Act, certain itemized deductions are phased out once a taxpayer's adjusted gross income (AGI) exceeds certain thresholds, which depend on the taxpayer's filing status. These limitations are known as the "Pease Limitation", named after former Ohio Representative Don Pease. In 2014, the AGI threshold for (a) married taxpayers filing jointly is $305,050, (b) married taxpayers filing separately is $152,525, (c) single taxpayers is $254,200, and (d) head of household is $ $279,650. See Rev. Proc. 2013-35 (October 31, 2013). The Pease Limitation require taxpayers with AGI in excess of the applicable threshold to reduce the amount of allowable itemized deductions by the lesser of (i) 3% of the excess of AGI over those thresholds, or (ii) 80% of the total amount of otherwise allowable itemized deductions. The following itemized deductions are subject to the Pease Limitation: (1) state and local taxes; (2) ***mortgage interest***; (3) charitable contributions; and (4) miscellaneous itemized deductions. The following itemized deductions are not subject to the Pease Limitation: (aa) medical expenses (which are already subject to a "floor" of 10%, reduced to 7.5% if one spouse is 65 or older); (bb) investment interest; and (cc) casualty, theft or wagering losses. The Pease Limitation applies only after the application of any other limitation on the itemized deduction. For example, the Pease Limitation applies to miscellaneous itemized deductions after the 2% AGI floor has been taken into account. Similarly, this limitation would apply to

charitable deductions after the various AGI limitations applicable to charitable deductions have been taken into account.

a. Example. Assume married taxpayers (filing jointly) have AGI during 2014, of $505,050. The taxpayers have $50,000 in itemized deductions consisting of (i) $40,000 of mortgage interest and tax deductions and (ii) a $10,000 of charitable contribution deduction (already taking into account the applicable AGI thresholds for charitable contributions). The taxpayers excess AGI over the threshold is $200,000. 3% of the Excess is $6,000. Therefore, the Pease Limitations reduce the taxpayer's itemized deductions to $44,000.

7. Interest Added to Principal Not Deductible. In October of 2014, the Tax Court ruled that a cash basis taxpayer delinquent on a real estate loan could not deduct past due interest owning on that loan even though that interest was added to the principal of a new loan refinancing the prior real estate loan.[2] The taxpayer may have able to obtain an interest deduction had the lender made an additional loan to the taxpayer and the proceeds of that additional loan were paid by the taxpayer to the lender in satisfaction of past due interest under the old loan; however, please note that the case law is mixed on this strategy.

8. Recent Proposals. In addition to the Pease Limitation, a number of proposals have been advanced regarding further limitations on the mortgage interest deduction. The proposals tend to focus on converting the deduction to a credit, capping the maximum mortgage amount, and limiting the credit to a primary residence. In late 2010, the President's Fiscal Commission proposed a 12% nonrefundable credit on up to a $500,000 mortgage, with no credit for a second residence or for home equity. The Debt Reduction Task Force suggested a 15% refundable tax credit which is capped, depending on the proposal, at $25,000 or $300,000 of primary mortgage debt. Other proposals suggest a 20% credit or having a fixed credit for owning a home as opposed to having a mortgage. The President's 20115 budget proposal revised a proposal from 2013 and 2014 that suggested capping itemized deductions, including mortgage interest, for taxpayers in the top tax brackets (33%, 35% and 39.6%). Under the proposal, these taxpayers would only be able to reduce their tax liability by a maximum of 28%.

C. Texas "Residence" Homesteads.

1. In General. Section 11.13(j) of the Texas Tax Code defines "residence homestead" to mean a structure (including a mobile home) or a separately secured and occupied portion of a structure (together with the land, not to exceed 20 acres, and improvements used in the residential occupancy of the structure, if the structure and the land and improvements have identical ownership) that: (a) is owned by one or more individuals, either directly or through a beneficial interest in a qualifying trust; (b) is designed or adapted for human residence; (c) is used as a residence; and(d) is occupied as the individual's principal residence by an owner or, for property owned through a beneficial interest in a qualifying trust, by a trustor or beneficiary of the trust who

2 See *Copeland*, TC Memo 2014-226.

qualifies for the exemption. A "trustor" means a person who transfers an interest in real or personal property to a qualifying trust, whether during the person's lifetime or at death, or the person's spouse. Texas Tax Code Section 11.13(j)(2). A qualified residential structure does not lose its character as a residence homestead where the owner temporarily stops occupying it as their principal residence if that owner does not establish a different principal residence and the absence is: (i) for a period of less than 2 years and the owner intends to return and occupy the structure as the owner's principal residence; or (ii) caused by the owner's: military service outside of the United States as a member of the armed forces of the United States or of this state or residency in a facility that provides services related to health, infirmity, or aging.

a. Qualifying Trust. Only individuals and "qualifying trusts" may own a "residence homestead" and qualify for the exemptions discussed below. A qualifying trust means a trust:

i. in which the agreement, will, or court order creating the trust, an instrument transferring property to the trust, or any other agreement that is binding on the trustee provides that the trustor of the trust or a beneficiary of the trust has the right to use and occupy as the trustor's or beneficiary's principal residence residential property rent free and without charge except for taxes and other costs and expenses specified in the instrument or court order: (a) for life, (b) for the lesser of life or a term of years, or (c) until the date the trust is revoked or terminated by an instrument or court order that describes the property with sufficient certainty to identify it and is recorded in the real property records of the county in which the property is located; and

ii. that acquires the property in an instrument of title or under a court order that (a) describes the property with sufficient certainty to identify it and the interest acquired, and (b) is recorded in the real property records of the county in which the property is located. Texas Tax Code Section 11.13(j)(3). Note that this definition was updated in 2013. See H.B. 2913, 83rd Leg., Reg. Sess. (Tex. 2013).

2. Tax Exemptions. Under Texas Tax Code Section 11.13, Texas homeowners may apply for certain homestead exemption on their principal residence. Homestead exemptions remove a portion of the home's value from taxation, reducing the homeowner's overall taxes. The exemptions vary depending on the taxing authority. For example, taxpayer's who qualify for the homestead exemption may receive (a) at least a $15,000 reduction in the value of their homestead for school district taxes, (b) a 20% reduction in the value of their homestead for county taxes, and (c) up to a 20% reduction in the value of their homestead for taxes assed by any other taxing unit (e.g., school district, city, county or special district, may offer an exemption for up to 20% of your home's value), provided that the optional exemption cannot be less than $5,000 regardless of the value of the residence. The governing body of each taxing unit decides whether it will offer the exemption and at what percentage. This percentage exemption is added to any other homestead exemption for which the applicant qualifies. There are additional exemptions for homeowners who are (i) 65 and older, (ii) disabled persons, (iii) disabled veterans and surviving spouses and children of deceased disabled veterans.

a. A qualified residential structure retains its character as a residence homestead even if a portion of the structure is rented to another or is used primarily for other purposes that are incompatible with the owner's residential use of the structure. However, the amount of any residence homestead exemption does not apply to the value of that portion of the structure that is used primarily for purposes that are incompatible with the owner's residential use.

3. House Bill 252. Effective September 1, 2011, the Texas Legislature revised the requirements to obtain a new property tax homestead exemption for a taxpayer's principal residence. The bill requires a copy of the homeowner's Texas driver's license or state identification card and the homeowner's vehicle registration receipt be sent with the homestead exemption application. If the homeowner does not own a vehicle, they can send a current utility bill showing name and address, along with an affidavit provided in the application indicating non-ownership of a vehicle. The address on the documents must match the address for which the homestead exemption is requested. The new law applies prospectively only and does not apply to homeowners who already have homestead exemptions. The law affects the applications for the general homestead exemption as well as the 65 and over exemption, the disability exemption, the disabled veterans exemption, the extended exemption for a homeowner's surviving spouse and the manufactured (mobile) home exemption.

D. Home Office.

1. In General. Section 280A(a) generally disallows deductions with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence. The disallowance rule of Section 280A(a) doesn't apply to any expense to the extent the expense is allocable to a portion of a dwelling unit:

a. that is exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer;

b. that is exclusively used on a regular basis as a place of business used by patients, clients or customers in the normal course of taxpayer's trade or business;

c. in the case of a separate structure that isn't attached to the home, that is exclusively used on a regular basis in connection with the taxpayer's trade or business;

d. to certain space used on a regular basis for storage of inventory or product samples by a wholesaler or retailer;

e. with respect to any portion of the dwelling unit used on a regular basis as a day care facility; or

f. to any item attributable to the rental of the dwelling unit, or to any portion of the dwelling unit.

2. Allocation Usage. In *Mears v. Commissioner*, the taxpayer argued that he used all of the rooms in his home exclusively for business purposes except for his son's bedroom and bathroom. TC Memo 2013-52 (February 19, 2013). According to the taxpayer's calculations, he used approximately 79% of his residence exclusively for business purposes. See Section 280A(c)(1). He sought depreciation deductions for business usage of his personal bedroom, kitchen, hallway, basement, and several other bedrooms. The Tax Court disallowed his claimed depreciation deductions, holding that the taxpayer had not proved that the claimed portions of the personal residence were exclusively used on a regular basis for the taxpayer's trade or business or that he regularly used portions of the home to store inventory or product samples.

3. Rev. Proc. 2013-13. Effective for tax years beginning on or after January 1, 2013, there is a new optional safe harbor method to determine the amount of an individual's deductible home office expenses. Taxpayers may elect to determine their deduction by multiplying a prescribed rate ($5.00) by the square footage of the portion of the taxpayer's residence used for business purposes. The allowable square footage is the portion of a home used in a qualified business use of the home, but not to exceed 300 square feet.

E. Vacation Homes.

1. General Rules. Generally, an individual or an S corporation taxpayer cannot take deductions with respect to a vacation home or other "dwelling unit" which is used by the taxpayer during the taxable year as a residence. Section 280A(a). However, this limitation does not apply to any deduction allowable by a taxpayer without regard to whether the expense is incurred in connection with a trade or business (e.g., interest, taxes, and casualty losses). Section 280A(b). Additionally, this limitation does not apply to items attributable to the rental of a vacation home. Section 280A(c)(3). For purposes of Section 280, a "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit and does not include that portion of a unit which is used exclusively as a hotel, motel, inn or similar establishment.

a. Residence or Rental Property. A home is treated as the homeowner's residence if, during the applicable tax year, the taxpayer's personal use exceeds the greater of (i) 14 days, or (ii) 10% of the days the property is rented to others during the year at a fair rental. Section 280A(d)(1). Conversely, a vacation home is treated primarily as rental property if, during the applicable tax year, the taxpayer's personal use of the unit does not exceed the greater of (i) 14 days, or (ii) 10% of the days the property is rented out during the year at a fair rental. Section 280A(g).

i. Example. John and Jane own a condo in Galveston, Texas. Their family uses it for vacation for three weeks during the summer and the couple rent it for approximately 250 days during the year. Because they used the condo for less than 25 days (i.e., the greater of 14 days or 10 percent of the rental days [250 * 10% = 25]), the condo does not qualify as a residence and is instead considered a rental property.

ii. Example. John and Jane own a condo in Galveston, Texas. Their family uses it for vacation for three weeks during the summer and the couple rent it for approximately 180 days during the year. Because they used the condo for more than 18 days (i.e., the greater of 14 days or 10 percent of the rental days [180 * 10% = 18]), the condo does qualify as a residence.

2. Vacation Home as Residence – Less than 15 Days Rented. If the taxpayer's vacation home is considered a residence, and it is actually rented for less than 15 days during the taxable year, the income derived from renting it out for the taxable year will not be included in the taxpayer's gross income under Section 61. Likewise, the taxpayer is not allowed to take any deductions otherwise allowable in connection with the renting of a vacation home. See Section 280A(g).

a. Example. Jay convinces his wife to rent out their house for the weekend of the Super Bowl when it comes to Houston in 2017 at a cost of $25,000 for the 4-day weekend (Friday through Monday). Assuming none of the above described rules change between now and then, the $25,000 is tax-free for federal income tax purposes.

3. Vacation Home as Residence –15 or More Days Rented. To the extent the taxpayer's vacation home is considered a residence and the taxpayer rents it out for 15 or more days a year, the owner must treat the rental portion of the vacation home separately from the personal portion. If a taxpayer uses a vacation home for personal purposes on *any* day during the taxable year, the amount attributable to (and therefore deductible by the taxpayer) the rental activities of the vacation home should be proportionate to the number of days during the taxable year that the vacation home is rented at a fair rental value over the total number of days during the taxable year in which the vacation home is used. Section 280A(e)(1).

a. Personal Portion. The homeowner deducts on Schedule A the real estate taxes and mortgage interest allocable to the taxpayer's personal use of the vacation home. Because personal use exceeds the greater of 14 days or 10% of the days it is rented out during the year, the vacation home is a qualified residence for purposes of the mortgage interest deduction. See Section 163(h)(4)(A)(i)(II). If the taxpayer does not own another vacation home, and the other rules for deducting qualified residence interest are met, the taxpayer can fully deduct the personal-use portion of the taxpayer's mortgage interest.

b. Rental Portion. Rental income is included on the taxpayer's Schedule E, but may be offset with deductions from the rental portion of expenses such as utilities, maintenance, upkeep, mortgage interest, real estate taxes and insurance. The homeowner also may claim a depreciation deduction relating to the rental use. However, the deductions are limited to the excess of rental income over: (1) deductions related to the rental activity itself (such as advertising, driving to the rental property to meet potential tenants, and broker's commissions) and (2) deductions allocable to the rental use which would be deductible whether or not the vacation home was rented out (such as interest and real estate taxes). See Section 280A(c)(5). Note that these rules are substantially similar to the Hobby Loss Rules under Section 183. Excess expenses are carried forward and may be used in a future year when there is additional rental income. Because the vacation homeowner's rental deductions for the year are effectively restricted by Section 280A(c)(5), the taxpayer does not have to worry about the passive loss rules for that year. See Section 469(j)(10).

c. Allocating Expenses. The IRS allows the apportionment of all expenses between rental and personal use based on the number of days used for each purpose. See Section 280A(e)(1); Prop Reg. § 1.280A-3(d)(3)(iii). The Tax Court and the Ninth and Tenth Circuits maintain that interest and taxes should be allocated to rental use based on the ratio of rental days to total calendar days (not just the number of days the vacation home is used). *See Bolton v. Commissioner*, 77 TC 104 (1981), *aff'd* 694 F2d 556 (9th Cir. 1982); *Buchholz v. Commissioner*, TC Memo 1983-378 (1983); *McKinney v. Commissioner*, 732 F2d 414 (10th Cir. 1983). All other expenses (e.g., utilities and maintenance) are allocated based on the ratio of rental days to total days of use.

i. Example. John owns a vacation home which he uses personally in August and rents out in June and July for $2,000. His total annual costs for this home are as follows: (1) mortgage interest - $1,200, (2) real estate taxes - $600, (3) maintenance - $600, (4) utilities - $300, and (5) depreciation, $1,200. John's vacation home is considered a residence since he personally uses it for more than the greater of 14 days or 10% of the rental use. Therefore, his deductions attributable to the vacation home will be limited to the gross rental income.

(a) Under the IRS's view (as set forth in the proposed regulations), John's deductions are as follows:

Gross rental	$ 2,000
Allocable share of real estate taxes and interest (2/3 x $1,800)	$ 1,200
Limit on deductions	$ 800
Allocable portion of maintenance and utilities (2/3 x $900)	$ 600
Balance	$ 200
Allocable depreciation, subject to income limit (2/3 x $1,200)	$ 200
Income	$ 0

John's depreciation deduction is limited to $200 (rather than the full $800 allocable to rental use), because of the gross rental income limitation. The remaining $600 depreciation deduction may be carried forward and taken into account as a rental expense for the next tax year, to the extent there is sufficient rental income. The remaining $600 in interest and taxes ($1,800 − $1,200) is allocable to John's personal use and is an itemized deduction. Note that the basis of the vacation home is not reduced to the extent of otherwise allowable depreciation that isn't deductible because it exceeds the rental gross income ceiling.

(b) Under the Courts' view (as described in the cases listed above), John's deductions are as follows:

Gross rental	$ 2,000
Allocable share of real estate taxes and interest (2/12 x $1,800)	$ 300
Limit on deductions	$ 1,700
Allocable portion of maintenance and utilities (2/3 x $900)	$ 600
Balance	$ 1,100
Allocable depreciation, subject to income limit (2/3 x $1,200)	$ 800

Income	$ 300

The remaining $1,500 in interest and taxes ($1,800 − $300) is allocable to John's personal use and is an itemized deduction. However, John must include the income from his rental activities under Section 61.

4. Vacation Home Used as Rental Property. To the extent the taxpayer's vacation home is considered rental property, the taxpayer's deductions are generally limited by the passive loss rules, not by the vacation home rules discussed above. As discussed above, if the taxpayer uses a vacation home for personal purposes on *any* day during the taxable year, the expenses associated with the vacation home must be allocated between personal use and rental use. Section 280A(e)(1).

a. Rental Activity. Under Section 469(c)(2), rental activity is generally treated as a per se passive activity regardless of whether the taxpayer materially participates. An activity is considered a rental activity in a given tax if (i) during such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and (ii) the gross income attributable to the conduct of the activity during such taxable year represents amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease). Reg. § 1.469-1T(e)(3)(i). However, the activity is not considered a rental activity if (1) the average period of customer use for such property is 7 days or less; (2) the average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers; (3) extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use); (4) the rental of such property is treated as incidental to a non-rental activity of the taxpayer (such as holding the property for investment or for use in a trade or business). Reg. § 1.469-1T(e)(3)(ii). Any activity not considered a rental activity is instead considered to be a trade or business, and the material participation rules will determine the taxpayer's ability to claim deductions of expenses associated with the activity. Compare this to the "active participation" rules discussed below.

b. Real Estate Professional. If a taxpayer is considered a real estate professional engaged in a real property trade or business, the taxpayer is not subject to the per se rule and instead is subject to the material participation requirements under Section 469(c)(1). See Section 469(c)(7); Reg. § 1.469-9(e)(1). A taxpayer qualifies as a real estate professional if: (i) more than one-half of the personal services performed in taxpayer's businesses are performed in real property business(es) in which the taxpayer materially participates; and (ii) the taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates. Section 469(c)(7)(B). For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is considered separately with respect to each rental property unless the taxpayer elects, by filing a statement with his original income tax return for the tax year, to treat all interests in rental real estate as a single rental real estate activity. Section 469 (c)(7)(A); Reg. § 1.469-9(e)(1). See *Schumann v. Commissioner*, TC Memo 2014-138 (July 14, 2014), in which the Tax Court applied the real estate professional requirements, finding that the taxpayer did not timely elect to treat all rental activities as one activity and did not substantiate his participation. The Tax Court held that the losses from the activities were passive losses, and that expenses associated with two cruise ship apartments which qualified as the taxpayer's residence (as discussed above) were limited by Section 280A.

c. Rental Portion. If the activity is considered a rental activity, and deductions allocable to the rental portion exceed rental income, the excess losses can generally only offset other passive income until the property is sold. However, if the taxpayer can prove he or she actively participates in the rental activity, and the taxpayer's AGI does not exceed $100,000, then the taxpayer can shelter non-passive income with up to $25,000 of losses from active-participation vacation rental activities. Section 469(i)(1), (2). The $25,000 allowance is reduced (but not below zero) by 50 percent of the amount by which the AGI of the taxpayer exceeds $100,000, and the allowance disappears completely when AGI reaches $150,000. Section 469(i)(3)(A). Note that this is tied to the taxpayer's total AGI, not the AGI from the rental activities. The active participation standard can be satisfied without regular, continuous, and substantial involvement as long as the taxpayer participates in a significant way. This would include making management decisions, such as approving new tenants, deciding on rental terms and approving capital or repair expenditures, or arranging for others to provide services. See S. Rept. No. 99-313, PL 99-514, 1986-3 CB 737. The $25,000 allowance is not available if a management or rental agent handles all aspects of renting the unit and maintaining it. *See, e.g.*, *Madler*, TC Memo 1998-112.

d. Personal Portion. The taxpayer receives a Schedule A itemized deduction for the real estate taxes allocable to the personal use of the vacation home. However, because the vacation home is not considered a qualified residence, the mortgage interest allocable to the taxpayer's personal use will be treated as nondeductible personal interest.

e. Relative's Use; Travel Time. In *Mark A. Van Malssen and Patricia D. Kiley*, TC Memo 2013-236, the Tax Court considered a couple of fine points related to calculating whether the taxpayers' use of a rental residential condominium exceeded fourteen days for purposes of the deduction limitation under Code Section 280A. The first point related to the use of the condominium by the one of the taxpayers' brother for seven days at less than full fair market value rental. Because the brother did not pay full fair market value rent, the brother's use of the condominium was attributed to the taxpayers as their personal use. The second point related to counting travel time to the condominium. The Tax Court held that the total number of personal use days for each year is determined by excluding days spent traveling to the realty to perform repairs and maintenance.

F. Tax Rates.

1. In General. Ordinary income for individual taxpayers is progressively taxed at 7 rates: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%. Section 1. The long-term capital gains varies based on the taxpayer's ordinary income bracket – taxpayers in the 10% and 15% ordinary income brackets pay 0% on capital gains, taxpayers in the 25%, 28%, 33%, and 35% ordinary income brackets pay 15% on capital gains and taxpayers in the 39.6% ordinary income bracket pay 20%. Section 1(h). However, taxpayers with modified AGI exceeding $250,000 (married filing jointly) or

$200,000 (single taxpayers), owe an additional 3.8% tax on all "net investment income" (discussed in more detail above).

2. Section 1245 Property. Upon the sale of "Section 1245 Property", taxpayers recognize ordinary income to the extent of deductions previously taken as to the property. Section 1245(a)(1). "Section 1245 Property" consists of (a) all depreciable personal property, whether tangible or intangible, and (2) certain depreciable real property (usually, real property that performs specific functions, for example, a storage tank, but not buildings or structural components of building).

a. Example. John buys a machine for use in his business for $50,000 and takes $30,000 of depreciation deductions. The deductions reduce John's basis in the machine to $20,000. John then sells the machine for $55,000, producing a gain of $35,000 of gain. $30,000 of the gain is considered depreciation recapture and the gain is subject to ordinary income tax rates. The remaining $5,000 is taxed under the netting rules.

3. Section 1250 Property. Straight line depreciation is the only method of depreciation allowed for Section 1250 Property (i.e., real property) under MACRS. Thus, if MACRS is used for real property, a 25% tax rate will apply to the extent the capital gain recognized does not exceed to cumulative amount of straight line depreciation previously deducted; all other capital gain will be taxed at customary long term capital gain rates. If the non-corporate taxpayer computes depreciation for realty other than under MACRS (e.g., depreciable realty placed in services before 1987), then upon the sale of "Section 1250 Property", a 25% tax rate will apply to the extent of gain recognized does not exceed to cumulative amount of straight line depreciation previously deducted and depreciation deductions taken in excess of straight-line depreciation will be taxed at the maximum rate (for non-corporate taxpayers) applicable to that taxpayer for ordinary income (i.e., up to 39.6%). Section 1250(c). "Section 1250 property" is all real property that is subject to an allowance for depreciation and that is not and never has been "Section 1245 property". Section 1250(c). This includes buildings, permanent improvements and structural components that are permanently fixed to the real property as well as leasehold interests subject to an allowance for depreciation. A fee simple interest in real property does not qualify as Section 1250 property because it is not depreciable. Note that property originally classified as Section 1250 property may be re-characterized as Section 1245 property and be treated as if it had always been Section 1245 property. If and when the converted Section 1250 property is later sold, all of the taxpayer's depreciation recapture tax liability will be calculated under Section 1245, including the period of in which the property was characterized as Section 1250 Property. See the discussion below regarding cost segregation studies and the allocation of property as Section 1245 Property or Section 1250 Property.

G. Alternative Minimum Tax. Individual taxpayers are subject to an alternative minimum tax ("AMT") in addition to the regular income tax computation. The AMT is (i) 26% of the first $175,000 of the taxpayer's alternative minimum taxable income in excess of the taxpayer's AMT exemption amount, and (ii) 28% of the taxpayer's alternative minimum income in excess of $182,500 or $91,250 for married taxpayers filing separately. Section 55. In 2014, the AMT exemption amount is $52,800 for single taxpayers and $82,100 for married persons filing a joint return. The AMT exemption is reduced by 25 percent of the amount by which alternative minimum taxable income exceeds $156,500 for married couples filing jointly ($117,300 for single taxpayers). Sections 55(d)(1)(A), (B). C corporations are also subject to the AMT at a rate of 20%, and receive an AMT exemption amount of $40,000. The taxable income subject to AMT is, generally, the taxpayer's taxable income increased by the amount of certain tax preferences, less certain itemized deductions. See Sections 56-58. Accelerated depreciation (i.e., depreciation in excess of straight line depreciation), passive activity losses, and installment sale net operating losses are examples of the more common tax preference items under the AMT.

1. Application to Real Estate. The AMT often comes into play when accelerated depreciation deductions are "recaptured" upon the sale of real property and taxed at 26%-28% where that individual has comparatively little other taxable income for the year. For "C" corporations, the AMT most often comes into play when a corporation has a net operating loss carryover and sells real estate. Corporate taxpayers with large prior net operating losses are sometimes surprised to learn that they must pay a 20% corporate AMT on their real estate gain.

H. Energy-Efficient Tax Credits.

1. Non-Business Energy Property Credit. Individual taxpayers may claim a personal income tax credit equal to the sum of: (1) 10% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the tax year, and (2) certain amounts of residential energy property expenditures. Section 25C(a). Not all energy-efficient improvements qualify, so taxpayers should check the manufacturer's credit certification statement. The credit only applies to US residents, and can be used to offset a taxpayer's AMT as well as their regular income tax. Note that this credit is not phased out for higher-income taxpayers.

a. Qualified Energy Efficiency Improvements. "Qualified energy efficiency improvements" are energy efficient building envelope components, such as (a) insulation materials or systems specifically and primarily designed to reduce heat loss/gain that meet criteria set by the International Energy Conservation Code (IECC); or (b) exterior windows, skylights or doors, or any metal roof with pigmented coating or asphalt roof with cooling granules specifically designed to reduce heat gain, installed on a dwelling unit that meet Energy Star program requirements. The component must be expected to last for at least five (5) years. Section 25C(c). This requirement is met if the manufacturer offers a two-year warranty to repair or replace at no extra charge.

b. Residential Energy Property Expenditures. "Residential energy property expenditures" are expenses for qualified energy property (including labor costs for onsite preparation, assembly, or original installation) that meets specific standards set out in Section 25C(d). The credit allowed for energy property expenditures cannot exceed:

i. $300 for any energy-efficient building property (electric heat pump water heater, electric heat pump; central air conditioner; natural gas, propane or oil water heater; or a stove burning biomass fuel to heat or provide hot water to a taxpayer's residence in the U.S.) that meets specific energy efficiency standards;

ii. $150 for a qualified natural gas, propane, or oil furnace; or qualified natural gas, propane, or oil hot water boiler; or

iii. $50 for an advanced main air-circulating fan.

c. Limitations. The nonbusiness energy property credit has a lifetime limit of $500. Section 25C(b)(1). If the total nonbusiness energy property credit taken in previous years (after 2005) is more than $500, the taxpayer cannot claim the credit for the current (or any future) tax years. Included in the lifetime limit are the credits taken in 2009 and 2010, when an aggregate $1,500 credit limit was in effect. No more than $200 of the $500 limit may be attributable to expenditures for windows. Section 25C(b)(2). However, unless Congress extends the applicable of this credit, it is only available for property placed in service before January 1, 2014. Section 25C(g)(2).

d. Example. John claimed nonbusiness energy property credits of $200 for 2007 and $500 for 2009. John cannot claim any further nonbusiness energy property credit, because his $500 limit has been exhausted.

e. Example. Jane claimed a $150 nonbusiness energy property credit for a qualified natural gas furnace in 2006. Jane claimed no other nonbusiness energy property credit for any pre-2013 year. For 2013, Jane can claim a nonbusiness energy property credit of up to $350 ($500 − $150), up to $200 of which can be for windows.

f. Example. Joe claimed a $200 nonbusiness energy property credit for energy-efficient windows in 2006 and a $50 credit for an advanced main air circulating fan in 2007. Joe claimed no other nonbusiness energy property credit for any pre-2013 year. For 2013, Joe can claim a nonbusiness energy property credit of up to $250 ($500 − $250). However, none of Joe's 2013 credit can be for windows, because her $200 limit for windows has been exhausted.

2. Residential Energy Efficiency Property. Individual taxpayers may claim a personal income tax credit for the purchase of residential energy efficient property placed in service before January 1, 2017 equal to the sum of 30% of the amount paid for: (i) qualified solar energy property (i.e., property that uses solar power to generate electricity in a home); (ii) qualified solar water heating property; (iii) qualified fuel cell property, up to a maximum $500 credit for each 0.5 kilowatt (kw) of capacity; (iv) qualified small wind energy property; and (v) qualified geothermal heat pump property. Section 25D(g). See Section 25D(a), (b)(1), (d). The taxpayer must install the qualifying equipment in a residence located in the United States, but it does not need to be a principal residence (i.e., installation of equipment in a vacation home will still qualify for the credit). The credit covers the cost of installation as well as hardware costs. Section 25D(e)(1). An expense is treated as made when the original installation is completed, except in the case of an expense for the construction or reconstruction of a structure, which is treated as made when the taxpayer's original use of the structure begins. Section 25D(e)(8). Taxpayers may rely on a manufacturer's certification that property meets the requirements for claiming the residential energy efficient property (REEP) credit. The taxpayer does not need to attach the certification to their tax return, but

should maintain records that establish entitlement to the credit. Notice 2009-41, Sec. 2.02(2), 2009-19 IRB 933.

a. State Credits. Many state and local governments and public utilities offer incentives for investment in renewable energy property, such as solar electric and solar heating systems. The most common incentives are rebates of a portion of the system's cost. Other incentives include state income tax credits, property tax exemptions, and state sales tax exemptions. A taxpayer may not take a credit for an expenditure to the extent that an energy conservation subsidy provided for that expenditure was excluded from the taxpayer's income. Section 136(b). An excluded subsidy is one that a public utility provides to a customer to buy or install an energy conservation measure.

3. Limitations Under Section 26(a). The 2012 Taxpayer Relief permanently extended the changes to Section 26(a). Therefore, for tax years beginning after 2011, a taxpayer's non-refundable personal credits cannot exceed the *excess* of (a) the regular tax liability *plus* the AMT (under Section 55(a)), *less* (b) the sum of (i) the credits under Sections 21 – 26 (but excluding Section 25C) *plus* (ii) any foreign tax credits for the taxable year. This is a significant change from pre-2011 laws, where the non-refundable personal credits could not exceed (a) the taxpayer's regular tax liability *less* (b) the AMT under Section 55(a), although certain tax credits were excluded from this limitation. To the extent personal tax credits exceed the limit described above, the excess can be carried forward to the next tax year. Section 25D(c).

a. Example. In 2012, John's regular income tax liability is $8,000, and his tentative minimum tax (AMT) is $7,200. Therefore, John must pay a regular income tax of $8,000, but no AMT. John can claim up to $8,000 of nonrefundable personal credits for 2012. Under pre-Act law, the amount of nonrefundable personal credits John could claim for 2012 would have been limited to $800—i.e., the excess of $8,000 regular tax over $7,200 tentative minimum tax.

b. Example. In 2012, John's regular income tax liability is $5,000, and his tentative minimum tax is $5,500. Therefore, John must pay a regular tax of $5,000, plus an AMT of $500 (excess of $5,500 tentative minimum tax over $5,000 regular tax). John can claim up to $5,500 of nonrefundable personal credits for 2012 (the sum of his $5,000 regular tax and $500 AMT). Under pre-Act law, John could not have claimed any nonrefundable personal credits for 2012, because his regular tax ($5,000) didn't exceed his tentative minimum tax ($5,500).

4. Claiming the Credits. Taxpayer's can claim both credits (to the extent they are applicable for a given tax year) by completing Form 5695.

IV. BASIS UPON ACQUISITION OF REAL ESTATE

Conceptually, basis is a running accounting record which prevents the same dollars from being subject to tax more than once and also prevents the same dollars from being deducted more than once. Determining basis is important for many reasons. First and foremost, basis is one of the components used in figuring the amount of gain or loss on the disposition of real estate (i.e., amount of gain or loss equals amount realized less basis). Section 1012. Basis is also one of the factors that determines the amount of depreciation deductions a taxpayer can take. The original or "unadjusted" basis for real property depends on how the property is acquired.

A. Basis Upon Purchase. In general, the basis of real estate acquired by purchase is the cost to acquire the real estate. Section 1012. This includes the price of real estate as well as any amounts the taxpayer spends to become the owner of the real estate, including the following: (i) escrow fee; (ii) disbursement and settlement of closing fees; (iii) attorney's fees attributable to the acquisition; (iv) title insurance paid by the purchaser; (v) recording fees; (vi) survey; (vii) preparation of title transfer documents; (viii) purchase commission (unusual but possible); (ix) option cost (even if paid years earlier); (x) Termite inspector's fees; (xi) Physical inspections (such as foundation, roof, mechanical, electrical, etc.); (xii) Transfer taxes; (xiii) Payment or assumption of taxes, interest and other expenses owed by the seller; (xiv) Governmental fees (for planning approvals, zoning, etc.); and (xv) loan costs, including: appraisal fees, appraisal review fees; credit application fees; attorney's fees attributable to loan closing; title insurance for lender's policy; broker fees or commission; survey cost attributable to the loan; points; and environmental inspections. These items can be written-off by "depreciation" or "amortization" (respectively) deductions. However, the cost of raw land cannot be depreciated or amortized.

1. <u>Amounts paid to sell property</u>. Commissions and other transaction costs paid to facilitate the sale of property are not currently deductible under Section 162 or Section 212. Reg. § 1.263(a)-1(e)(1). Instead, the amounts must be capitalized and reduce the amount realized in the taxable year in which the sale occurs or are taken into account in the taxable year in which the sale is abandoned if a deduction is permissible. These amounts are not added to the basis of the property sold. However, in the case of a dealer in property, amounts paid to facilitate the sale of such property are treated as ordinary and necessary business expenses. Reg. § 1.263(a)-1(e)(2).

a. <u>Example</u>. A owns a parcel of real estate. A sells the real estate and pays legal fees, recording fees, and sales commissions to facilitate the sale. A must capitalize the fees and commissions and, in the taxable year of the sale, must reduce the amount realized from the sale of the real estate by the fees and commissions. However, if A is a dealer in real estate, the commissions and fees paid to facilitate the sale of the real estate may be deducted as ordinary and necessary business expenses under Section 162.

b. <u>Practice Tip.</u> Taxpayers frequently do not keep track of what expenses should be added to basis while they are in the process of acquiring and developing real estate. Therefore, tax advisers are often asked to assist real estate owners in determining their original basis long after acquisition of the real estate. In this regard, one good source is the real estate seller's or buyer's closing statements received from the title company. However, because many costs are often paid outside of closing, tax advisers should review the owner's canceled checks for the year of purchase as well as the preceding year to find costs of environmental studies, appraisals, loan application fees, physical inspections, etc.

B. Basis Upon Gift. The rules determining basis of real estate acquired by gift are designed to prevent income tax avoidance. Generally, the taxpayer receiving the real estate takes the same basis as the person who gave the taxpayer the real estate (commonly referred to as "carryover" basis). Section 1015. However, if the FMV of the real estate is less than the carryover basis, the basis is reduced to the fair market value of the real estate at the time of the gift. Section 1015(d). This effectively keeps the donor from giving away losses inherent in real estate. If any gift taxes are paid as a result of the gift, the gift tax paid is added to the taxpayer's basis. This adjustment is limited to the gift tax on the appreciation of the real estate while owned by the donor of the real estate. However, the adjustment for gift tax paid cannot increase the basis above the FMV of the real estate at the time of the gift. A gift of appreciated real estate potentially results in the transfer of depreciation recapture.

C. Basis Upon Inheritance. If a taxpayer inherits real estate from a decedent, the basis in the inherited real estate will be the FMV of the real estate at the time of the decedent's death, regardless of whether a federal estate tax return is filed for the decedent. Section 1014(a). Congress recognized the "creative tax planning" that could be developed by gifting low basis real estate to someone near death with the expectation that the taxpayer would receive the real estate back from the decedent's estate. *See former* § 1023(a). In 1981, Congress enacted a special rule applicable to appreciated property given to a decedent within one year of the decedent's death. If the real estate has built-in gain and is re-acquired from the decedent by the donor of the property or the donor's spouse, then the basis of the property in the donor's or spouse's hands is the same as it was in the decedent's hands immediately prior to death (i.e., its "carryover" basis). See Section 1014(e).

1. <u>Practice Tip</u>. Notice that this tax planning opportunity still exists if (1) the real estate is reacquired by someone other than the donor taxpayer (such as possibly a spendthrift, generation-skipping trust of which the donor taxpayer is a primary beneficiary) or his or her spouse or (2) the low basis real estate was transferred to a decedent more than one year prior to the decedent's death.

D. Basis Upon Exchange. Very generally speaking, in a like-kind exchange of real estate (discussed below in more detail), the basis of the recipient owner in the real estate received in the exchange is the same as it was in the real estate traded (so-called "substituted basis"), plus any gain which is taxable due to the exchange, plus any additional debt and transaction costs incurred in the exchange. See Sections 1012, 7701.

E. Basis Allocation. If a taxpayer acquires more than one (1) piece of property or parcel (or one tract which will be sold off in parcels) at the same time, the purchase price must be allocated among the properties or parcels to determine the basis of each. The applicable income tax regulations provide that this is a fact question, which must be done in a fair and equitable manner, usually based on the relative fair market value of each property or parcel at the time of purchase. The purchaser may determine allocations based on bona fide offers received from willing buyers, appraisals made by a qualified appraiser, or sometimes assessed values imposed by the county assessor (if reasonable). Amounts set forth in a purchase agreement are acceptable as proof of a proper allocation if the allocation is the result of arm's length bargaining and has a substantial effect on both parties. If the allocation is made solely for the benefit of one party, however, or if it gives rise to an artificial value or unreasonable tax result to one party, it will likely be disregarded. In most cases, however, an allocation set forth in a purchase agreement will be respected where the parties have opposing interests (i.e., one party is adversely affected by the allocation which is beneficial to the other party).

1. Practice Tip. Careful basis allocation can be helpful in situations where a developer incurs debt to purchase several parcels together or a large tract which will be subdivided and sold in several parcels, or where a real estate investor simply wants to defer paying income tax. In situations involving purchase money debt, it is common for the lending bank or other financial institution to require all proceeds from the first sale(s) of real estate to be used to pay-down the debt owed to it. In these situations, the taxpayer can find himself having to pay income taxes on "phantom" income (i.e., taxable income without current cash for the payment of tax on that income) since the lender has taken all of the sales proceeds in repayment of the purchase money debt.

2. Example. John purchases a large tract of real estate ("Blackacre") for $1,000,000. John pays 20% in cash and finances the rest of the purchase price with a bank loan. The bank takes a first lien against Blackacre under a deed of trust. John plans to sell roughly 1/4 of Blackacre on December 31 for $550,000 (the "First Parcel"). The deed of trust contains partial release provisions which permit John to sell the First Parcel, provided the bank receives all of the $550,000 sale proceeds. If John allocates 1/4 of his $1,000,000 basis or $250,000 to the First Parcel, he will have "phantom income" of $300,000 (i.e., $550,000 amount realized less $250,000 basis). If John is in an effective 40% income tax bracket, the $300,000 of "phantom income" will result in $120,000 of tax currently due. The bank refuses to allow John to grant a second lien on Blackacre to borrow the funds necessary to complete the payment of his tax on the $300,000 "phantom income." Therefore, unless he has other funds, John has a $120,000 tax deficiency, subject to interest and non-payment penalties. One solution to the phantom income tax problem is to negotiate with the lender to allow John to retain enough sales proceeds to pay the taxes attributable to the sale of the First Parcel. Another possible solution is adjusting the manner in which the $1,000,000 basis is allocated. For instance, because the First Parcel is the most valuable part of Blackacre, John may be able to justify a disproportionately higher basis allocation to the First Parcel. If John allocates $500,000 of basis to the First Parcel, his "phantom income" is reduced to $50,000 (i.e., $550,000 amount realized less $500,000 basis). At an effective income tax rate of 40%, John's current tax bill is only $20,000.

V. ADJUSTED BASIS AND CAPITALIZATION.

After the original acquisition of real property, the original basis in the real estate is increased or decreased to reflect events occurring after the real estate's acquisition. Section 1016. The net adjustments to the original basis while the taxpayer holds the real estate will determine the "adjusted basis" of the property. The basis will be decreased each year by the amount of depreciation and amortization deductions and the amount of deductible losses due to a fire or other casualty. The amount received as damages or in settlement of a claim may be treated as a tax-free reduction of basis rather than taxable income if it represents a return of capital rather than recovery of lost profits. For example, a payment by a contractor in exchange for a release of the buyer's claims for a failure to meet requirements of a construction contract will be treated as a return of capital and reduce basis (rather than as taxable gain). The basis in the property increases each year for costs incurred in connection with the property, including (i) the cost of improvements which are not currently deductible, (ii) legal fees to defend title or reduce tax assessments, interest and taxes paid during construction/development, and (iii) demolition costs.

A. Capitalization of Construction Period Expenses. Construction-period interest and taxes must be added to basis and written-off over the recovery period for the real estate (i.e., 27.5 years for residential real estate and 39 years for non-residential real estate). See Sections 168(c), 263. Until construction actually begins, however, interest and taxes are deductible. The construction period is generally regarded as commencing when physical work begins (*i.e.*, "scraping the dirt"). Note, however, that land assemblage and soil testing are considered pre-construction period activities. Real property taxes accruing during the construction period must be allocated between non-depreciable land and depreciable improvements. Interest on the construction loan presumably must be allocated fully to depreciable improvements, but if debt is incurred in connection with the acquisition of land, interest on debt is probably non-depreciable and recoverable only when the land is sold (although the law is not currently clear on this point). Determining the amount of interest subject to capitalization can require an elaborate accounting analysis. The amount of interest which must be capitalized includes the interest directly traceable to the construction indebtedness plus any interest expense during the construction period that could have been avoided if funds (e.g., from contributions of capital) had not been expended for construction. Stated differently, if construction expenditures exceed construction debt, interest on non-construction debt must be capitalized to the extent of the excess. Note that **i**nterest and taxes accruing up through land assemblage and soil testing are currently deductible and do not have to be capitalized.

B. Capitalization of Construction Costs. In Chief Counsel Advice 200913011 (November 25, 2008), the IRS concluded that hotel rooms in a casino-hotel entertainment complex (the "Complex") were functionally interdependent and comprised a single unit of property for purposes of the uniform capitalization rules under Reg. § 1.263A-10. During construction of the Complex, the owner and operator of the Complex capitalized interest on the indebtedness attributable to the Complex's construction costs under Section 263A(f). Relying on Reg. § 1.263A-10(b)(6), Exs. 3, 5, and 7, the taxpayer represented that each hotel room was intended to be separately "leased" or held out for the production of income. For purposes of the interest capitalization computation, the taxpayer grouped the hotel rooms by floor, concluding that the rooms on one floor had contemporaneous production periods and stopped capitalizing interest for a hotel room once the floor had been deemed completed and was available for use. The CCA determined that a room or a floor in the hotel were not multiple units of property as contemplated in Exs. 3, 5, and 7 in Reg. § 1.263A-10(b)(6). Under Reg. § 1.263A-10(b)(2), real property components are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. The CCA reasoned that none of the facts indicated that the hotel was intended to operate for the production of income without the casino having also been approved and operating.

C. Capitalization and/or Deductibility of Repairs and Maintenance. The IRS recently released final regulations governing when taxpayers must capitalize and when they can deduct expenses associated with acquiring, maintaining, repairing and replacing property. See T.D. 9636, September 13, 2013. The final regulations made significant changes to a long series of proposed regulations under Code Sections 162(a) and 263(a). See, e.g., 71 FR 48590 (8/21/2006), 73 FR 12838 (3/10/2008), TD 9564; 76 FR 81060 (12/27/2011), Notice 2012-73 (2012-51 IRB 713). After considering all of the comments and the statements made at the public hearing on the 2011 temporary and proposed regulations, the IRS and the Treasury Department removed the 2011 temporary regulations under Code Sections 162, 165, 167, 263(a), 263A, 1016, and § 1.168(i)-7 and issued final regulations. The IRS and the Treasury Department also removed the 2011 proposed regulations and issued new proposed regulations regarding the disposition of property under Section 168. In general, the final regulations apply to taxable years beginning on or after January 1, 2014, although certain rules apply only to amounts paid or incurred in taxable years beginning on or after January 1, 2014.

1. General Overview. Section 263(a) generally requires the capitalization of amounts paid to acquire, produce, or improve tangible property and provides that no deduction is allowed for (1) any amount paid for new buildings or permanent improvements or betterments made to increase the value of any property or estate, or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. Reg. 1.263(a). Regulations previously issued under Code Section 263(a) provided that capital expenditures included amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt the property to a new or different use. For example, the following amounts paid are examples of capital expenditures: (i) an amount paid to acquire or produce a unit of real or personal tangible property. See § 1.263(a)-2; Reg. § 1.263(a)-1(d)(1); (ii) an amount paid to improve a unit of real or personal tangible property. See §1.263(a)-3, Reg. § 1.263(a)-1(d)(2); or (iii) an amount paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land. See Reg. § 1.263(a)-1(d)(5). By comparison, Section 162 allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including the costs of certain supplies, repairs, and maintenance. The final regulations provide a general framework for distinguishing capital expenditures from supplies, repairs, maintenance, and other business expenses that are deductible under Section 162.

2. Materials and Supplies. Subject to certain limitations, amounts paid to acquire or produce "materials and supplies" are generally deductible in the tax year in which it is first used or consumed by the taxpayer. Reg. § 1.162-3(a)(1). However, a taxpayer may elect to capitalize (and treat as an asset subject to the allowance for depreciation) the cost of rotable spare parts, temporary spare parts and standby emergency spare parts (as defined in Reg. §§ 1.162-3(a)(2), (3)). This annual election is made on the taxpayer's tax return, and is subject to certain exceptions. See Reg. § 1.162-3(d)(2). The regulations define "materials and supplies" as tangible property that is used or consumed in the taxpayers operations that is not inventory and that is:

a. a component acquired to maintain, repair, or improve a unit of tangible property (as determined under §1.263(a)-3(e)) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;

b. consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations;

c. a "unit of property" (as determined under Reg. § 1.263(a)-3(e)) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations. Note that the economic useful life is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or the period over which the property may reasonably be expected to be useful to the taxpayer for the production of income. See Reg. § 1.162-3(a)(4);

d. a unit of property that has an acquisition cost or production cost of $200 or less; or

e. otherwise identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies for which treatment is permitted under this section.

3. De Minimis Safe Harbor. The regulations provide for a de minimis safe harbor, under which a taxpayer is not required to capitalize amounts paid to produce or acquire a unit of property. Reg. § 1.263(a)-1(f)(1). Note that "produce" means construct, build, install, manufacture, develop, create, raise or grow. Reg. § 1.263(a)-1(c)(2). The rules vary depending on whether the taxpayer has an "applicable financial statement".

a. Applicable Financial Statement. An "applicable financial statement" is: (1) a financial statement that is required to be filed with the Securities and Exchange Commission (SEC) (e.g., a 10-K); (2) a certified, audited financial statement that is accompanied by the report of an independent certified public accountant used for (A) credit purposes; (B) reporting to shareholders, partners, or similar persons; or (C) any other substantial non-tax purpose; or (3) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency.

b. Taxpayer with Applicable Financial Statement. A taxpayer electing to apply the de minimis safe harbor may not capitalize under §1.263(a)-2(d)(1) or §1.263(a)-3(d) nor treat as a material or supply under §1.162-3(a) any amount paid in the taxable year if -

i. The taxpayer has an applicable financial statement in place at the beginning of the taxable year;

ii. The taxpayer has at the beginning of the taxable year written accounting procedures treating as an expense for non-tax purposes (1) amounts paid for property costing less than a specified dollar amount; or (2) amounts paid for property with an economic useful life (as defined in §1.162-3(c)(4)) of 12 months or less;

iii. The taxpayer treats the amount paid for the property as an expense on its applicable financial statement in accordance with its written accounting procedures; and

iv. The amount paid for the property does not exceed $5,000 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance in the Federal Register or in the Internal Revenue Bulletin.

c. Taxpayer without Applicable Financial Statement. A taxpayer electing to apply the de minimis safe harbor may not capitalize under §1.263(a)-2(d)(1) or §1.263(a)-3(d) nor treat as a material or supply under §1.162-3(a) any amount paid in the taxable year if -

i. The taxpayer does not have an applicable financial statement;

ii. The taxpayer has at the beginning of the taxable year accounting procedures treating as an expense for non-tax purposes (1) amounts paid for property costing less than a specified dollar amount; or (2) amounts paid for property with an economic useful life (as defined in §1.162-3(c)(4)) of 12 months or less;

iii. The taxpayer treats the amount paid for the property as an expense on its books and records in accordance with these accounting procedures; and

iv. The amount paid for the property does not exceed $500 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance in the Federal Register or in the Internal Revenue Bulletin.

d. Annual Election. This safe harbor election must be made annually by the taxpayer, and is exercised by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year. The election applies to all qualifying expenses, including materials and supplies that meet the requirement. Said another way, the taxpayer cannot exclude certain qualifying expenses and include others; it is an all-or-nothing election.

4. Routine Maintenance. Amounts expended for certain routine repair and maintenance of tangible property are not required to be capitalized. Routine maintenance is considered a recurring activity that the taxpayer expects to perform to keep a unit of property in its ordinary efficient operating condition. The safe harbor applies to activities that the taxpayer reasonably expects to perform more than once during the class life of the property, as determined under the MACRS alternative depreciation schedule of section 168(g). If the activity only occurs once during the useful life, then it is a capitalized betterment. Routine maintenance includes maintenance with respect to, and the use of, rotable spare parts. Routine maintenance excludes activities that follow a basis recovery event similar to the items that are described as restorations. The final regulations expand the routine maintenance safe harbor to allow expensing of routine maintenance activities on a building and its structural components (including building systems). To qualify, the taxpayer must reasonably expect to perform the relevant activities more than once during a ten-year period, beginning at the time the building property is placed in service.

a. The final regulations confirm that routine maintenance can be performed any time during the life of the property, provided that the activities qualify as routine under the regulation. For purposes of determining whether a taxpayer is performing routine maintenance, the final regulations remove the taxpayer's treatment of the activity on its applicable financial statement from the factors to be considered. Taxpayers may have several different reasons for capitalizing maintenance activities on their applicable financial statements, and such treatment may not be indicative of whether the activities are routine. The final regulations also clarify the applicability of the routine maintenance safe harbor by adding 3 items to the list of exceptions from the routine maintenance safe harbor: (1) amounts paid for a betterment to a unit of property, (2) amounts paid to adapt a unit of property to a new or different use, and (3) amounts paid for repairs, maintenance, or improvement of network assets. The first two exceptions were included in the general rule for the safe harbor in the 2011 temporary regulations, but were not clearly stated as exceptions. The exception for network assets was added because of the difficulty in defining the unit of property for network assets.

b. Note that the 10-year period regarding building maintenance may disqualify certain maintenance items, especially those related to "smart" building and other low maintenance structures. However, a taxpayer's reasonable expectation of whether it will perform qualifying maintenance activities more than once during the relevant period will be determined at the time the unit of property (or building structure or system, as applicable) is placed in service. The final regulations modify the safe harbor for routine maintenance by adding that a taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the relevant period, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Thus, for a unit of property previously placed in service, whether the maintenance is actually performed more than once during the relevant period is not controlling for assessing the reasonableness of a taxpayer's original expectation.

5. Election to Capitalize Repair and Maintenance Costs. The 2011 temporary regulations did not contain an election for taxpayers to capitalize expenditures made with respect to tangible property that would otherwise be deductible under these regulations. This treatment may not be consistent with the how the taxpayer treats such costs for financial accounting purposes. In response to comments to this potential issue, the final regulations permit a taxpayer to elect to treat amounts paid during the taxable year for repair and maintenance to tangible property as amounts paid to improve that property and as an asset subject to the allowance for depreciation, as long as the taxpayer incurs the amounts in carrying on a trade or business and the taxpayer treats the amounts as capital expenditures on its books and records used for regularly computing income. Reg. § 1.263(a)-3(n). Under the final regulations, a taxpayer that elects this treatment must apply the election to all amounts paid for repair and maintenance to tangible property which it treats as capital expenditures on its books and records in that taxable year. A taxpayer making the election must begin to depreciate the cost of such improvements when the improvements are placed in service by the taxpayer. The election is made by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which the improvement is placed in service. Once made, however, the election may not be revoked. A taxpayer that capitalizes repair and maintenance costs under the election is still eligible to apply the de minimis safe harbor, the safe harbor for small taxpayers, and the routine maintenance safe harbor to repair and maintenance costs that are not treated as capital expenditures on its books and records.

6. Improvements. The final regulations continue to require capitalization of amounts paid to improve a unit of property and retain the rules of the 2011 temporary regulations for determining the unit of property and for determining whether there is an improvement to a unit of property. Generally, a unit of property is improved if amounts are paid for activities performed by the taxpayer which result in (a) a betterment to the property, (b) a restoration of the unit of property, or (c) adaptation of the unit of property to a new or different use. Reg. § 1-263(a)-3. The final regulations also retain the simplifying conventions set out in the 2011 temporary regulations, including the routine maintenance safe harbor and the optional regulatory accounting method.

a. Determining a Unit of Property. The final regulations generally define a unit of property as consisting of all the components of property that are functionally interdependent, but provide special rules for determining the unit of property for buildings, plant property, and network assets. The final regulations also provide special rules for determining the units of property for condominiums, cooperatives, and leased property, and for the treatment of improvements (including leasehold improvements). The final regulations retain the unit of property rules contained in the 2011 temporary regulations.

b. Betterment. In general, amounts paid which result in the betterment of a unit of property must be capitalized. Determining whether an expenditure results in a betterment is a facts and circumstances test, including, but not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure on its applicable financial statement. An amount paid results in a betterment of a unit of property only if it –

i. Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

ii. Is for a material addition (including a physical enlargement, expansion, extension or addition of a major component) to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or

iii. Is reasonably expected to materially increase the productivity, efficiency, strength, quality or the output of the unit of property. Reg. § 1.263(a)-3(j)(1)(i)-(iii).

When a particular event necessitates an expenditure, the determination is made by comparing (i) the condition of the property immediately after the expenditure with (ii) the condition immediately prior to the circumstances necessitating the expenditure. Reg. §1.263(a)-3(j)(2)(iv)(A). If the costs are incurred to correct normal wear and tear to the unit of property, the taxpayer must compare (i) the condition of the unit of property to (ii) the condition of the unit of property the last time the taxpayer corrected the normal wear and tear (whether paid for maintenance or improvements. If the taxpayer has not previously performed any maintenance of correct normal wear and tear, then the taxpayer must compare the present condition of the property to the condition of the property when placed in service by the taxpayer. Reg. §1.263(a)-3(j)(2)(iv)(B).

c. Restoration. A taxpayer must capitalize amounts paid to restore (as compared to "refreshing") a unit of property. Reg. §1.263(a)-3(k)(1). An amount is paid to restore a unit of property only if it –

i. Is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. §1.165-7);

ii. Is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

iii. Is for the repair of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under Section 165, or relating to a casualty event described in Section 165, subject to the limitation in paragraph (k)(4) of this section;

iv. Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

v. Results in the rebuilding of the unit of property to a like-new condition after the end of its class life; a unit of property is built to a like-new condition if it is brought to the status of new, rebuilt, manufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications; or

vi. Is for the replacement of a part (or a combination of parts) which comprises a "major component" or a "substantial structural part" of a unit of property. Reg. §1.263(a)-3(k)(1)(i)-(iv).

An amount is paid to improve a building if it is paid to restore a building, condominium, cooperative or leased building or portion of building. Reg. §1.263(a)-3(k)(2). For example, an amount is paid to improve a building if it is paid for the replacement of a part or combination of parts that comprise a major component or substantial structural part of the building structure or any one of its building systems (for example, the HVAC system).

d. New or Different Use. Taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. Reg. §1.263(a)-3(l)(1). In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer. In the case of a building, an amount is paid to improve all or a portion of the building if it is paid to adapt to a new or different use. For example, an amount is paid to improve a building if it is paid to adapt the building structure or any one of its buildings systems to a new or different use. Reg. §1.263(a)-3(l)(2).

e. Small Taxpayer Safe Harbor. The final regulations added a safe harbor election for "small taxpayers", who were concerned about the costs associated with maintaining the documentation necessary to apply the improvement rules discussed above. Under the exception, small taxpayers are not required to capitalize improvements if the total amount paid for repairs, maintenance, improvements and similar activities during the tax year does not exceed the lesser of $10,000 or 2% of the unadjusted basis of the building. Reg. §1.263(a)-3(h)(1). Amounts paid for repairs, maintenance, improvements, and similar activities performed on eligible building property include those amounts not capitalized under the de minimis safe harbor election and those amounts deemed not to improve property under the safe harbor for routine maintenance. Reg. §1.263(a)-3(h)(2). A taxpayer is considered a "small taxpayer" if the taxpayer's annual gross receipts for the 3 preceding tax years do are $10 million or less. Reg. §1.263(a)-3(h)(3).

D. Capitalization Is Not All Bad. A special provision of the tax law permits the owner of unimproved and unproductive real estate to elect to capitalize real estate expenses, interest and other carrying charges rather than deducting them currently as expenses. Section 266. This election may be advisable where a taxpayer does not have sufficient income to offset real estate property taxes or interest. Without this election, the expenses would be of no tax use. By capitalizing the expenses, a taxpayer can increase his basis in the real estate and thereby lower his taxable gain upon subsequent sale of the real estate.

VI. DEPRECIATION.

A. Overview. If a tangible asset is depreciable, the taxpayer is entitled to a series of annual deductions up to an amount not in excess of the asset's basis. Depreciation is typically calculated pursuant to a formula which provides for a theoretical annual percentage decrease in the asset's basis over a given recovery period. Typically, recovery periods will be set at a number of years roughly equivalent to the asset's useful life. An asset is "depreciable" only if: (1) the nature of the property is such that it should decline in value over time, and (2) it is used in a business or held for investment. Land, inventory, and personal residences are not depreciable. The nature of the asset determines the length of its recovery period. For administrative ease and other reasons, the applicable tax law (generally known as "MACRS") categorizes property into different groups or classes, with each class having a different recovery period.

B. MACRS Property Classification. All property is assigned to a class with a recovery period that (in theory) most closely resembles the property's anticipated useful life. For example, cars are assigned to the class of property having a five (5) year recovery period and must be depreciated over five (5) years (i.e., "five-year property"). The following classes of property most commonly affect real estate investors (See Section 168(c)):

1. 5-year property: telephone switching equipment.

2. 7-year property: (i) most personal property normally associated with a building, such as (a) furniture, fixtures and equipment, (b) carpet tacked down (but not glued), (c) exterior lighting, (d) exterior signage not imbedded in a concrete base, (e) moveable wall partitions, (f) telephone poles, (g) truck bay doors, (h) ornamental fixtures and pictures (but not art work), (i)

closed-loop cooling systems for multiple business tenants (see PLR 201121010), and (j) any property which does not have an assigned class life and is not otherwise classified. *See Consolidated Freightways, Inc.*, 74 T.C. 768 (1980), *aff'd in part and rev'd in part on other grounds*, 708 F.2d 1385 (9th Cir. 1983).

3. 10-year property: certain single purpose agricultural or horticultural structures (e.g., equipment sheds, chicken coups, milking barns and horse barns).

4. 15-year property: most land improvements, such as (i) paved roads, parking lots and sidewalks, (ii) landscape sprinkler systems and drains, (iii) newly planted landscaping (if it would be destroyed upon demolition or replacement of the building), (iv) finish grading around other land improvements (but not under the building), (v) buried pipes and lines not serving the building, (vi) fences, (vii) bridges, tunnels and canals, (viii) excavation for a lagoon (less the value of fill kept on site), (ix) certain wastewater plants, (x) qualified leasehold improvements, (xi) qualified restaurant property, and (xii) qualified retail improvement property.

5. 27.5-year property: residential real estate (defined to include buildings or structures where 80% or more of the gross rental is from dwelling units, excluding hotels, motels and similar living accommodations used on a transient basis).

6. 31.5-year property: certain § 1250 property placed in service before May 13, 1993, or between May 12, 1993 and January 1, 1994, that has a class life of at least 27.5 years and is not residential rental property (e.g., a hotel).

7. 39-year property: non-residential real estate.

C. Rates of Depreciation. Each depreciation class also has a different rate or method of depreciation applicable to the class. For example, 5-year and 7-year property is generally eligible for the "200% declining balance" depreciation method. 15-year property is eligible for the "150% declining balance" depreciation method. Residential real estate (i.e., 27.5-year property) and non-residential real estate (i.e., 39-year property) are only eligible for the "straight line" method of depreciation method.

1. Section 179 Expenses. Section 179 may provide significant benefits for the year in which property is placed in service. Under Section 179, certain taxpayers may elect to treat all or some of the cost of certain qualified property as a deductible expense. "Qualifying property" for these purposes is property purchased for use in the active conduct of a trade or business that is (1) depreciable tangible property; (2) computer software; and (3) Section 1245 property.

2. "Qualified Real Property". Under Section 179(f), "qualified real property" is also considered "qualifying property" under Section 179. Qualified real property must be Section 1250 property that is (1) qualified leasehold improvement property described in Section 168(e)(6); (2) qualified restaurant property described in Section 168(e)(7); or (3) qualified retail improvement property described in Section 168(e)(8). See Section 179(f)(2)(C). Additionally, the property must be depreciable, acquired for use in the taxpayer's active trade or business, and cannot be ineligible

property, such as (i) property used for lodging, outside the U.S., by governmental units, by foreign persons or entities, by certain tax-exempt organizations, or (ii) air conditioning or heating units. See Section 179(f)(1)(C). Section 179(f) allows the deduction of up to $250,000 of capital expenditures for qualified real property, which is included within the overall $500,000 expenditure limit of Section 179. The American Taxpayer Relief Act of 2012 included an extension of Section 179(f) to tax years beginning in 2013. However, the Tax Increase Prevention Act of 2014 included an extension of Section 179(f) through 2014.

a. Qualified leasehold improvement property. Qualified leasehold improvement property includes interior building improvements that are (a) Section 1250 property, (b) made "under or pursuant to a lease" (as defined in Section 168(h)(7), namely any grant of a right to use property), either by the lessee, sublessee or lessor of the building portion, (c) in a portion of the building to be occupied exclusively by the lessee (or any sublessee), (d) placed in service more than three years after the date the building was first placed in service. (Section 168(k)(3)(A), Reg. § 1.168(k)-1(c)(1)), and (e) qualify for bonus first-year depreciation (Section 168(e)(6)). If a lessor makes an improvement that is a qualified leasehold improvement, it generally cannot be a qualified leasehold improvement property to any subsequent owner. The Code does not define what types of building improvements are eligible to be treated as qualified leasehold improvement property. Rather, it lists the types of property which cannot be treated as qualified leasehold improvement property, including (1) the enlargement of the building; (2) any elevator or escalator; (3) any structural component benefiting a common area; and (4) the internal structural framework of the building. Section 168(k)(3)(B). Therefore, the following types of improvements would appear to qualify, if they benefit the tenant's space only rather than a common area: (aa) electrical or plumbing systems (including a sprinkler system); (bb) permanently installed lighting fixtures; (cc) ceilings and doors; and (dd) heating or cooling equipment, air conditioners, and other air handling equipment.

b. Qualified restaurant property. Property is qualified restaurant property if it is a building or an improvement to a building which is Section 1250 property and if more than 50% of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals. Section 168(e)(7).

c. Qualified retail improvement property. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. Section 168(e)(8)(C). Additionally, qualified retail improvement property must be open to the general public and used in the retail trade or business of selling tangible personal property to the general public, and the improvement in question must be placed in service more than three years after the building was first placed in service. Section 168(e)(8).

3. Limits & Phase-out on Section 179 Expensing. The maximum amount of aggregate expenses that may be taken into account under Section 179 in 2013 is $500,000. However, this $500,000 limit is phased out dollar-for-dollar to the extent the aggregate cost of all Section 179 property of a taxpayer placed in service during the taxable year exceeds $2,000,000. Further, under

Section 179(b)(3), the allowable Section 179 deduction may not exceed the taxable income derived from the active conduct of the taxpayer's trade or business. Any disallowed deductions may not be carried forward to tax year beginning after 2013. Section 179(f)(4)(A). Under, the Tax Increase Prevention Act of 2014 included an extension of Section 179(f), the maximum amount of aggregate expenses that may be taken into account under Section 179 remains at $500,000 through the end of 2014.

4. Election Required. The taxpayer must elect under Section 179 to treat the cost of the property as not chargeable to a capital account. Second, the taxpayer must elect under Section 179(f) to treat qualified real property as Section 179 property. The dollar limits discussed above, as well as the phase-out threshold, apply to limit the effectiveness of the election. Before making the election to treat qualified real property as Section 179 property, taxpayers should consider whether the election will cause the total cost of their Section 179 property placed in service during the tax year to exceed $2,000,000. Additionally, before electing to expense qualified real property as Section 179 property, the taxpayer should consider whether that election will affect the availability of expensing deductions for Section 179 property other than qualified real property. Taxpayers do have a chance to change their minds if the election turns out to be disadvantageous. Under Section 179(d)(1)(A)(ii), a taxpayer may revoke a Section 179 election without IRS consent. The election and/or revocation may be made on a timely-filed amended federal tax return for the tax year to which the revocation or election applies.

a. Example: RDP LLC, a calendar-year taxpayer, placed $500,000 of five (5) year MACRS property into service in a new Houston restaurant. Before the end of the year, it places $2,000,000 of qualified restaurant property in service. If it makes the Section 179(f) election to expense qualified restaurant property, it will effectively wipe out its entire Section 179 deduction (i.e., $500,000 expensing limit – [$2,500,000 total of Section 179 property minus the $2,000,000 phase-out threshold] = zero). If it does not make the Section 179(f) election, RDP LLC can expense the full $500,000 of five (5) year MACRS property placed in service earlier this year (if it has enough taxable income) since the total amount of Section 179 property won't reach the $2,000,000 phase-out threshold.

5. Allocation of Amounts. For purposes of applying the qualified real property carryover limitation and the Section 179(b)(3)(B) general carryover rules to any tax year, the amount which is disallowed under Section 179(b)(3)(A) (the taxable income limitation) for that tax year which is attributed to qualified real property is the amount which bears the same ratio to the total amount so disallowed as: (x) the aggregate amount attributable to qualified real property placed in service during that tax year, increased by the portion of any amount carried over to that tax year from an earlier tax year which is attributable to qualified real property, bears to (y) the total amount of Section 179 property placed in service during that tax year, increased by the aggregate amount carried over to that tax year from any earlier tax year. Section 179(f)(4)(D). For purposes of the allocation rules, only Section 179 property for which an expensing election was made (without regard to amounts disallowed under Section 179(f)(4)(B)) is taken into account. Section 179(f)(4)(D).

a. Multiple Section 179 Properties. If taxpayers place in service multiple Section 179 properties that have a total cost in excess of the dollar limitation, the standard wisdom is to make the Section 179 for the properties with the longest depreciation periods. This approach generally maximizes the acceleration of deductions. However, because of the qualified real property carryover limitations discussed above, taxpayers subject to the taxable income limitation on Section 179 deductions should, in some situations, choose not to make the Section 179 election for qualified real property, even if that property has a longer depreciation period than the taxpayer's other Section 179 properties.

b. Example: In 2012, RDP LLC, a calendar-year taxpayer, placed in service $500,000 of 5-year and 7-year MACRS property. In its final quarter, it places in service $250,000 of qualified real property. It has no Section 179 carryovers from previous years, and has $300,000 of taxable income for 2012 and $200,000 for 2013. If RDP elects to expense $250,000 of the 5-year and 7-year MACRS property, and $250,000 of the qualified real property, the amount disallowed under the taxable income limitation and attributable to the qualified real property will be $100,000 (i.e., [$250,000 qualified real property for which expensing was elected ÷ $500,000 total expensing election] × $200,000 disallowed amount because of the taxable income limitation). The amount disallowed under the taxable income limitation and attributable to the 5-year and 7-year MACRS property also will be $100,000. None of the $100,000 expensing carryover from 2012 attributable to qualified real property may be carried over to a tax year beginning after 2012, and RDP will be treated for depreciation purposes as if it had placed $100,000 of qualified restaurant property in service in 2012. For 2013, RDP will be able to offset only $100,000 of its taxable income with $100,000 of carried-over expensing deductions from 2012. In essence, it will have lost $100,000 of expensing deductions. Had RDP elected to expense the entire $500,000 of 5-year and 7-year MACRS property in 2012, and none of its $250,000 of qualified real property, it would have been able to use expensing to offset $300,000 of taxable income in 2012, and $200,000 of taxable income in 2013.

D. Depreciation Planning. When it comes to deductions, sooner is usually better than later. Therefore, the shorter the recovery period, the greater the present value of the deductions. The significance of planning to maximize depreciation deductions should not be overlooked. Careful planning of depreciation deductions for real estate generally involves three (3) techniques to boost depreciation deductions:

1. Cost Segregation Study. A cost segregation study can be performed to reclassify portions of the building as (i) personal property (or Section 1245 property), or (ii) land improvements (or Section 1250 property), both of which are eligible for more rapid depreciation. Personal property deductions under MACRS are fully taken after 5-years and 7-years (depending on the property) and land improvements deductions are fully taken after 15 years. By conducting a cost segregation study and segregating tangible personal property, depreciation deductions are not increased but the taxpayer will benefit from shorter recovery periods and possibly increased first year expensing benefits under Section 179. For example, if personal property in a building can be identified and segregated from the building, it can be separately depreciated over 7 years rather than 27.5 or 39 years.

a. Reg. § 1.48-1 is helpful in determining which components are structural and thus not eligible for personal property classification. The regulation refers to property that "relates to the operation or maintenance of a building" and may include walls, floors, and ceilings, and permanent covers such as windows and doors, as well as central air conditioning, electrical wiring, plumbing and fixtures, and sprinkler systems. Other guidelines that help to identify tangible personal property include answering questions such as whether the property can be moved, how difficult it would be to remove it, whether it is designed to remain permanently in place, and whether there are circumstances that tend to show the intended length of affixation.

b. While the idea behind cost segregation is simple, the practice can be difficult because the taxpayer must (i) identify eligible personal property, (ii) analyze cost data and (iii) prepare cost breakdowns. The best time to perform a cost segregation study is when the building is purchased, constructed or renovated. A cost segregation study should not be based on "non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records." See CCA 199921045.

2. Allocating Basis Between Land and Building. Applicable tax law sets no specific guidelines for allocating costs between land and improvements. Therefore, taxpayers are left to rely on the past court decisions in deciding how acquisition costs should be allocated between land and improvements. Approved allocation methods include:

a. Contract Allocation Method. A purchase contract may contain an allocation of the purchase price between the land and the building. The IRS and the courts will not accept this type of allocation unless it has an economic effect on both parties and results from legitimate negotiations between parties who have interests which are adverse to one another.

b. Appraisal Method. An appraisal of the property by a professional appraiser will carry some weight with the IRS and the courts. However, none of the traditional appraisal methods (i.e., market, cost, and income approaches) directly allocate costs between land and buildings. Consequently, the traditional appraisal solution uses either the building residual method or the land residual method.

c. Building Residual Method. Under the building residual method, the land value (as unimproved) is estimated from sales of comparable parcels. The resulting land value is then subtracted from the total value of the entire property to arrive at the building value.

d. Land Residual Method. Alternatively, this method is often used when the building represents a proper (highest and best) use of the site and the building value can be reliably estimated. In some cases, the replacement cost of building improvements has been subtracted from the total value of the real estate to arrive at the residual value of the land.

e. Property Tax Assessments Method. In some cases, courts have determined that land and building allocations may be based on local real estate tax assessments. However, for this method to be successfully accepted, there must be some evidence that the valuation is a realistic one.

E. Non-Depreciated Land and Depreciable Land Improvements. After establishing a favorable land-to-building cost allocation and working through a cost segregation analysis for personal property, planning can still be directed to the physical aspects of property to identify the "land improvements" noted above, in order to maximize depreciation deductions. Land improvements, such as sidewalks, parking lots, roads, landscaping, and fences, can generally be depreciated at more than twice the rate of a non-residential building (i.e., 15 years vs. 39 years), are not included in the definition of 27.5-year residential property, 31.5-year property or 39-year property and appear to qualify for the 150% declining balance method over a 15-year period. *See* Rev. Proc. 87-56, 1987-2 C.B. 674.

1. Example. Jane purchases for $280,000 a small commercial office building for her production company. Closing costs total $12,000 and general improvements to the building (e.g., new paint, carpet, new appliances, elephant light fixtures, etc.) cost an additional $25,000. Jane finances approximately $235,000 of the cost to acquire the building with a local bank at a 9.5% interest rate (she's a credit risk) and a repayment schedule amortized over 15 years, subject to a five (5) year balloon. Jane's loan payments are $2,454 per month (exclusive of real estate taxes and insurance), which are comprised (on an average monthly basis) of approximately $1,698 as a deductible interest expense and $756 as a reduction of principal. Also, assume Jane allocates 30% of the building's acquisition cost to the land on which the building is situated. Jane's annual depreciation expense over the term of the loan will be $5,333.33, i.e., 1/39th of $208,000 ([$280,000 x 70%] + 12,000). This means his monthly depreciation expense will only be $444 ($5,333.33/12). This is in sharp contrast to Jane's average monthly principal reduction of $756. While principal reduction on real estate purchase money loans is not deductible, Jane gets a depreciation deduction for a portion of what the principal purchased, i.e., the building improvements. Therefore, for every dollar of rent Jane collects that is used to reduce the principal of the loan, she only has 58.74 cents of depreciation deduction, with the balance (i.e., 41.36 cents per $1.00 of rent paid against principal) being "phantom" income (i.e., taxable income without current cash for the payment of the tax attributable to that income). Over the course of each full year of the loan, this means there will be an average of $2,200 of phantom income per year (i.e., [.4136 x $444] x 12 = $2,200). This phantom income may be temporarily avoided somewhat by carefully planning for increased annual depreciation deductions.

F. Recapture. Depreciation deductions provide two significant tax benefits – the deferral of tax and the conversion of rent as ordinary income into capital gains However, depreciation deductions do not eliminate tax altogether since the real estate owner must reduce his basis in the real estate by the amount of the depreciation deductions. Additionally, depreciation recapture minimizes the benefits of depreciation write-offs by taxing sale gains at ordinary income rates rather than capital gains rates to the extent of "accelerated" depreciation deductions. Also, sale gain will be taxed at 25% rather than 20% to the extent of un-recaptured straight-line depreciation deductions previously taken. Accelerated depreciation is depreciation in excess of straight-line depreciation. Depreciation recapture will affect land improvements and personal property depreciated under MACRS. See the discussion regarding Section 1245 Property and Section 1250 Property above. However, since most real estate other than land improvements are depreciated using the straight-line method, the conversion of ordinary income into capital gain is still available.

1. Example: John purchases a four-plex for $390,000 with cash and no debt. He allocates $100,000 of basis to the land underlying the four-plex and the remaining $290,000 of basis to the building improvements. He holds the four-plex for five (5) years and claims depreciation deductions totaling $52,727 ([$290,000 divided by 27.5 years] x 5 years). While he held the four-plex, John paid no income tax on $52,727 of the rental income he collected because this rental income was "tax-sheltered" by depreciation deductions. Assuming John is in an effective income tax bracket of 35%, he was able to avoid paying $18,454 in income tax he otherwise would have paid on the rental income ($52,727 x 35%). However, John's basis in the four-plex was reduced by the depreciation deductions, thereby producing the potential for future gain. John sold the four-plex after five (5) years at his original purchase price of $390,000 (net of selling expenses). Consequently, John incurred a capital gain of $52,727 ($390,000 sales price minus his adjusted basis of $337,273 ($390,000 less $52,727 of depreciation deductions) taxable at 25% as unrecaptured Section 1250 gain at a tax cost of $13,182. Therefore, John deferred paying tax on $52,727 until he sold the four-plex and when he eventually did pay taxes on the amount, the taxes were at a 25% capital gains rate of rather than a 35% ordinary income rate, effectively saving him $5,272 ($18,454 less $13,182) plus the time-value of money over five (5) years.

VII. SALE OF REAL PROPERTY

A. Dealer Status. The federal income tax consequences of a real estate activity differ greatly depending on whether the owner primarily holds the real estate (i) for sale to customers in the ordinary course of a trade or business or (ii) for productive use in a trade or business or as an investment. Real estate held primarily for sale to customers in the ordinary course of a trade or business as "dealer property," while the term "investor property" is often used to describe real estate held for productive use in a trade or business or as an investment. The distinction between investor property versus dealer property is significant since "dealer" property is not eligible for (i) long term capital gain treatment, (ii) depreciation, (iii) like-kind exchange treatment under Section 1031, or (iv) installment sale treatment under Section 453. In addition, gain from dealer realty may be subject to (i) self-employment tax under Section 1401, (ii) in the case of tax-exempt organizations or qualified plans, unrelated business income tax under Section 511, or (iii) in the case of real estate investment trusts, the 100% prohibited transactions tax under Section 857(b)(6).

1. Benefits of Investor Status. For long term capital gain treatment, Section 1221(a) defines a "capital" asset as property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but specifically excludes *". . . property held by the taxpayer primarily for sale to customers in the ordinary course of his or her trade or business"*. Similarly, Section 1231(a)(3)(A) says "section 1231 gain" includes any recognized gain on the sale or exchange of *property used in the trade or business,* and Code §1231(b)(1), in defining "property used in the trade or business," excludes *property of a kind which would properly be included in inventory of the taxpayer* . . ." The key definitional language is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" or "property . . . properly . . . included in inventory." Whether a taxpayer intends to hold a property for resale, or to hold for investment, is the critical issue. This analysis is commonly known as the "dealer versus investor test", and requires numerous factual determinations, none of which are controlling. The continued differential between the tax rates for long-term capital gains and all other kinds of income brings heightened significance

to a real estate owner's status as a "dealer." Dealer status (resulting in ordinary income) and investor status (resulting in capital gains treatment) is determined on a taxpayer by taxpayer basis. For example, authority exists which says that dealer status is determined at the partnership level as opposed to the partner level. However, because limited partnerships are each separate taxpayers for this purpose, the dealer status (if any) of one partnership should not affect the non-dealer status of another limited partnership.

a. A taxpayer's intent in holding a property is a question of fact, and it is the taxpayer's intent at the time of sale which is determinative. *Cottle v. Commissioner*, 89 T.C. 467, 487 (1987); *Austin v. Commissioner*, 263 F.2d 460, 461 (1959). Often, the taxpayer's initial intent suggests the intent at the time of sale. *Neal T. Baker Enters. v. Commissioner*, 76 T.C.M. 301 (1998). However, taxpayers have frequently demonstrated a changed intent, from being a "dealer" to begin an "investor" at the time of sale. Proving intent can be difficult. As a general rule, taxpayers tend to be more successful in proving a change in intent where they can demonstrate the change took place for a suitable period prior to the sale rather than on the eve of sale. See *Tibbals v. U.S.*, 362 F.2d 266, 273 (1966); *Eline Realty Co. v. Commissioner*, 35 T.C. 1, 5 (1960). Further, the Fifth Circuit has stated that, where unanticipated, externally induced factors or events occur, changed intent will be more convincing. See *Biedenharn Realty Co. v. U.S.*, 526 F.2d 409, 421 (5th Cir. 1976).

2. 5th Circuit Factors in Determining Dealer Status. In *Suburban Realty Co. v. U.S.*, 615 F.2d 171 (5th Cir. 1980), the Fifth Circuit developed a framework for determining whether sales of land are considered sales of a capital asset or sales of property held for sale to customers in the ordinary course of a taxpayer's business. The three principal questions that must be considered are --Was the taxpayer engaged in a trade or business, and if so, what business? Was the taxpayer holding the property for sale in that business? Were the sales contemplated by the taxpayer "ordinary" in the course of that business? The *Suburban Realty* court looked to the earlier Fifth Circuit decision in *Biedenharn Realty Co. v. U.S.*, 526 F.2d 409 (5th Cir. 1976) for seven factors that should be considered when answering these three questions. The factors that should be considered are:

a. the nature and purpose of the acquisition of the property and the duration of the ownership;

b. the extent and nature of the taxpayer's efforts to sell the property;

c. the number, extent, continuity and substantiality of the sales;

d. the extent of the subdividing, developing, and advertising to increase sales;

e. the use of a business office for the sale of the property;

f. the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

g. the time and effort the taxpayer habitually devoted to the sales.

See also *U.S. v. Winthrop*, 417 F.2d 905, 910 (5th Cir. 1969). The frequency and substantiality of sales is the most important factor, although no one factor alone is decisive. *Suburban Realty*, 615 F.2d at 178; *Biedenharn*, 526 F.2d at 416. The extent of development activity and improvements also seems to carry significant weight. Given the multi-factor analysis, diversifying the risk as to dealer status is generally advisable. Note that authority exists for the argument that a taxpayer's status as a dealer of residential property does not necessarily classify the taxpayer as a dealer of commercial property.

3. Other Factors in Determining Dealer Status. For taxpayers outside of the Fifth Circuit, the Tax Court has developed other factors to determine whether a taxpayer is considered a dealer or an investor. However, these lists of "dealer" factors in should be less of a concern for taxpayers residing in the Fifth Circuit since the *Suburban Realty* factors listed above should apply. See, e.g., *Jack E. Golsen*, 54 TC 742 (1970).

a. In *Fraley v. Commissioner*, the Tax Court confirmed the "attribute" laundry list that needs to be examined to determine the owner's intent. This list of attributes was compiled based on a series of Sixth Circuit decisions, in which the court upheld the axiom that, "whether land is held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is a purely factual determination." See *Case v. United States*, 633 F.2d 1240, 1245 (6th Cir. 1980); *Gartrell v. United States*, 619 F.2d 1150, 1152-1153 (6th Cir. 1980); *Philhall Corp. v. United States*, 546 F.2d 210, 214 (6th Cir. 1976); *Maddux Construction Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970). The attributes include the following:

i. The purpose for which the property was acquired.

ii. The purpose for which the property was held.

iii. The extent of improvements made to the property.

iv. The frequency of sales.

v. The nature and substantiality of the transactions.

vi. The nature and extent of the taxpayer's dealings in similar property.

vii. The extent of advertising to promote sales.

viii. Whether the property was listed for sale either directly or through brokers.

b. In *Phalen v. Commissioner*, the Tax Court applied the taxpayer's factual situation to the attributes discussed in the *Fraley* decision. TC Memo 2004-206. The activities articulated in *Phalen* are similar to those an investor may have to undertake to maximize the value of his investment without crossing the line to engage in "dealership." The *Phalen* attributes include:

i. The owners of the development entity (some of whom were real estate developers in their other activities and owned their interests in the same percentages as investors) did not taint the taxpayer partnership's investment status. However, the individuals, personally, were not real estate brokers or agents.

ii. "Development" activities (in this context, physical improvements) were not directly undertaken by the investor partnership.

iii. A guarantee by the investment partnership of the performance of the development agreement was not fatal.

iv. The investment partnership succeeded to rights under agreements put in place by the former bankrupt developer/owner, and assumption of these rights did not taint the investment purpose.

v. The investment partnership's participation in financing the activity of the developer who was the buyer and financing the municipal improvement district (which was obligated to construct the improvements) was not fatal.

vi. The sale of multiple tracts to different buyers over four years was acceptable. All sales were unsolicited.

vii. Soil testing to evaluate the development alternatives for the property was acceptable.

viii. The investor partnership's participation in amended and final site plans was acceptable.

ix. All corporate and partnership formalities were carefully followed-even between related investor/dealer entities.

x. Good business reasons existed for the sale to related (through ownership) development entities and for structuring of activity among the investment partnership, municipal improvement district, and the financing.

c. In *Allen v. United States*, the taxpayer in *Allen* (a construction engineer by trade) admitted to originally acquiring the subject realty for the purpose of developing and reselling it. 2014-1 U.S.T.C. (CCH) ¶50,300 (N.D. Cal. 2014). He argued, though, that over time he decided not to develop the property, but continued to hold it "for investment" until he could sell all of the realty, which finally occurred twelve years after the initial acquisition. The Tax Court granted summary judgment in favor of the IRS and found that the taxpayer originally acquired the property for development and resale, and that the taxpayer failed to adequately prove he changed his intent to "holding the property for investment." In deciding for the IRS, the court focused on the following facts: (i) from 1987 to 1995, the taxpayer attempted to develop the property on his own; (ii) the taxpayer admitted his initial intention to develop the property on his own, and searched for partners to help in the property's development; (iii) from 1995 to 1999, the taxpayer brought in partners who contributed capital for development; (iv) in 1999, the taxpayer sold the property to a developer for a lump sum (used to pay-off encumbering debt and prior partners), along with 22% of the buyer's profits and a set fee per developed lot sold; and (v) the taxpayer made significant efforts to develop the property over many years (e.g., the preparation of 10 engineering studies in respect to the subject realty) and failed to substantiate when his actions changed with regard to the property. It is interesting to note that there was no mention of whether the taxpayer ever engaged in any marketing activities for the realty at issue or made any physical improvements. The result in *Allen* may not have been the same if decided by or in the Fifth Circuit, given the precedence of *Suburban Realty* and given (i) Allen's twelve year holding period, (ii) no prior sales, (iii) lack of physical improvements, (iv) minimal if any marketing activities, and (v) that the taxpayer in Allen appears to have decided to simply liquidate the investment.

d. Practice Tip. Real estate developers frequently establish separate limited partnerships or other entities in an effort to avoid dealer status. This strategy is more likely to succeed if the separate entities are established at different times with different partner-investors. Occasionally, a real estate developer uses a wholly-owned limited liability company that is a disregarded entity for federal income tax purposes. The unfortunate real estate developer in such a situation has achieved nothing with respect to avoiding dealer status. It should also be noted that care should also be taken to avoid operating the businesses of these separate entities as alter egos. Additionally, it may be useful to avoid using the word "development" in naming entities, or in describing the purpose of an entity, which will construct and own real estate. IRS agents often point to the use of the word "development" when arguing that the entity has dealer status.

4. Subdividing Into Lots. A taxpayer's subdivision of a tract into separate lots is strong evidence that the taxpayer is in the business of selling real estate in the ordinary course, although the Fifth Circuit has held that such activities do not affect investment status when used as reasonable means of disposing of the property. *See Temple vs. United States*, 229 F. Supp. 687, *aff'd*, 355 F.2d 67 (5th Cir. 1966); *see also Buono v. Commissioner.*, 74 T.C. 187 (1980) (subdividing land into separate lots for purposes of enhancing selling price not evidence of dealer status where intention was to sell land as single tract). The IRS has not acquiesced in this distinction, however. *See* Rev. Rul. 59-91, 1959-1 CB 15. However, Section 1237 grants capital gains treatment under certain circumstances even though subdividing activities have occurred. Section 1237 permits an individual who is not otherwise determined to be a real estate dealer to subdivide and sell real estate, without running the risk of being deemed a dealer solely because of the subdividing and sales activities. In order to qualify for Section 1237 treatment, the taxpayer must (i) hold the property for at least five (5) years, unless the property is acquired by inheritance; (ii) not make any improvements that substantially enhance the value of the parcel sold; and (iii) not sell lots or parcels that have been previously held for sale to customers in the ordinary course of business, and in the year of sale, the taxpayer must not have held any other real property as a dealer. A taxpayer who fails to meet Section 1237's requirements may still be deemed to be an investor and not a dealer.

B. Like-Kind Exchanges. Gains or losses on the sale or exchange of real property are generally taxable in the year of sale or exchange. However, certain "like-kind" exchanges meeting the requirements in Section 1031 can defer the tax recognition. In a like-kind exchange, the gain inherent in the real property being sold (the "Relinquished Property") is deferred until the real property acquired in the trade (the "Replacement Property") is sold. This is generally accomplished by allowing the taxpayer to substitute his or her basis in the Relinquished Property as the basis in the Replacement Property. Note that losses are also not recognized in a Section 1031 exchange. While deferral of the recognition of taxable gain on the sale of an asset is the primary benefit of a like-kind exchange, there are additional benefits. While a full discussion of like-kind exchanges is beyond the scope of this outline and covered elsewhere in today's presentations, below is a summary of the basic requirements to complete such an exchange.

1. Elements of a Like-Kind Exchange. Under Section 1031, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment, if the Relinquished Property is exchanged solely for Replacement Property which is of a "like-kind" and is to be held either for productive use in a trade or business or for investment.

a. Exchange Requirement. In order to complete a like-kind exchange, there must be an actual "exchange" of eligible property. When Section 1031 was enacted, the IRS argued that any "exchange" (i.e., passage of title) must occur simultaneously for the exchange requirement to be satisfied. Any exchange involving an exchange agreement or binding promise to exchange was not considered an exchange of "like-kind" property unless the exchange was simultaneous. However, the Ninth Circuit held in *Starker* that the simultaneous exchange of title was not significant where the taxpayer had signed an agreement binding them to an exchange. *Starker v. U.S.*, 602 F2d 1341 (9th Cir. 1979). After *Starker*, taxpayers had more flexibility to structure exchanges that occurred in a series of "steps" which eventually led to the practice of multi-party and deferred exchanges (discussed below).

b. The Like-Kind Requirement. To be eligible for a tax-free like-kind exchange under Section 1031, both the Relinquished Property and the Replacement Property must satisfy the following two tests:

i. Like-Kind Test. The properties must be of a "like-kind." "Kind" refers to the class, nature or character of the property, rather than to its use or function or to its grade or quality. Section 1031(a). For example, the fact that any real estate involved is improved or unimproved is not material because that relates only to the grade or quality of the property and not to its kind or class. Treas. Reg. § 1.1031(a)-1(b). Virtually all interests in real property (excluding interests in minerals) are deemed to be of a like-kind with one another, and it is probably safe to say that most exchanges under Section 1031 involve real estate. However, U.S. real estate and foreign real estate are not considered "like-kind" nor is the exchange of interests in real estate partnerships. See Section 1031(a)(2)(D). Also, generally speaking on exchange of real estate owned "in fee" will not be like-kind to leased realty unless the lease is for a term of 35 or more years. Note that goodwill or going concern value of one business is not like-kind to the goodwill or going concern value of another business. *See* Reg. § 1.1031(a)-2(c)(2).

ii. Business or Investment Test. An exchange does not qualify if either the Relinquished Property or Replacement Property is held for the transferor's personal use; rather, both properties must be used in the taxpayer's business or held for investment. Section 1031(a). Therefore, it is possible that one party will qualify for Section 1031 treatment but the other party will not. Note, however, that Section1031 does not apply if either property consists of inventory in the hands of the transferor. In *Moore v. Commissioner*, T.C. Memo 2007-134, the Tax Court ruled that a vacation home was not eligible for like-kind exchange treatment because the mere expectation that the home will appreciate does not mean that the home was held for investment. The court indicated that indicia of investment intent would be making the property available for rent or holding either property primarily for sale at a profit.

iii. Real Property. The like-kind standard for real property is extremely broad, and generally all real property is like-kind to all other real property, with some noted exceptions. Under the Regulations, a lease of 30 years or more is real property for purposes of Section 1031 regardless of its state law characterization. As described above, in making a determination of like-kind status, consideration is given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.

Examples of real property exchanges held to be like-kind are:

- Unimproved real property for unimproved real property; Reg. § 1.1031(a)-1(c);
- Commercial building for lots; *Burkhard Inv. Co. v. U.S.*, 100 F.2d 642 (9th Cir. 1938);
- City real estate for a ranch or farm; Reg. § 1.1031(a)-1(c);
- One property for more than one property and vice versa; *Coupe v. Comm'r*, 52 T.C. 394 (1969);
- A tenancy-in-common interest for a fee interest and vice versa; Rev. Rul. 79-44, 1979-1 C.B. 265;
- An easement for a fee interest; Rev. Rul. 72-549, 1972-2 C.B. 472;
- Perpetual water rights for a fee interest where water rights are real property under state law; Rev. Rul. 55-749, 1955-2 C.B. 295;
- A fee for a fee, subject to a 99 year lease; *Koch v. Comm'r*, 71 T.C. 54 (1978);
- A fee for a leasehold interest with 30 years or more to run (all unexercised option periods are included in meeting the 30 year requirement); Reg. § 1.1031(a)-1(c); *See also Peabody Natural Res. Co. v. Comm'r*, 126 T.C. at 275; *Century Elec. Co. v. Comm'r*, 15 T.C. 581, 591–592, 1950 WL 77 (1950), *aff'd*, 192 F.2d 155 (8th Cir.1951); Rev. Rul. 78-72, 1978-1 C.B. 258);
- A remainder interest in one property for life estate in another property where the life tenant has a life expectancy of at least 30 years; Rev. Rul. 78-4, 1978-1 C.B. 256;
- A conservation easement for a fee interest in timberland, farm land or ranch land; PLR 9621012; and

- A natural gas pipeline that is real property in one state and personal property in another state. CCA 201238027.

Examples of real property exchanges held NOT to be like-kind are:

- A fee for services; *Badgett v. U.S.*, 175 F. Supp. 120 (W.D. Ky. 1959);
- A fee interest in timberland for cutting rights; *Oregon Lumber Co. v. Comm'r*, 20 T.C. 192 (1953);
- Water or mineral rights of limited duration for a fee interest; Rev. Rul. 55-749, 1955-2 C.B. 295; and
- An attached railroad track for an unattached railroad track. TAM 200424001.

iv. Oil, Gas, and Mineral Interests. When a mineral lease gives the lessee the right to extract the minerals for a set period of time, or until exhaustion, the lessor retains a royalty interest. The lessee's interest in a mineral lease is a real estate interest for federal income tax purposes. *Palmer v. Bender*, 1933-1 C.B. 235 (1933); Rev. Rul. 68-226, 1968-1 C.B. 362. This is true even if the mineral lease is considered personal property for state law purposes. Rev. Rul. 68-226, 1968-1 C.B. 362. Working interests may also contain equipment and other tangible personal property, in which case an exchange of working interests could be a multi-asset exchange if there is personal property. *Id*.

A royalty interest, which is a nonworking interest, provides that the holder will receive a designated percentage of all minerals without regard to the operator's cost to extract those minerals. A royalty interest is also considered a real property interest for federal income tax purposes and would be exchangeable. Rev. Rul. 73-428, 1973-2 C.B. 303. Similarly, an overriding royalty interest has been held to be like-kind to unimproved real estate. Rev. Rul. 72-117, 1972-1 C.B. 226. Conversely, a production payment is not considered real property for federal income tax purposes and will not qualify for exchange treatment under Section 1031. Section 636 ("A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property."). "Carved out" interests like production payments are treated differently than overriding royalty interests and other interests because of the duration of the interests. An overriding royalty interest exists until the mineral deposit is exhausted whereas a carved out oil payment right terminates when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received. *See Koch*, at 65. A profits interest is like a royalty interest and will be considered real estate unless limited like a production payment. Rev. Rul. 73-541, 1973-2 C.B. 206.

In Rev. Rul. 68-331, the IRS stated that the exchange of a producing oil lease for the fee interest in a ranch constituted a nontaxable exchange of realty to the following extent:

> Accordingly, the exchange by the taxpayer of his leasehold interest in a producing oil lease (not including personal property, stock in trade, or other property held primarily for sale), extending until the exhaustion of the deposit, that is held for productive use in trade or business or for investment, for the fee interest in the improved ranch to be held for productive use in trade or business or for investment is an exchange of property for property of a like kind under section 1031(a) of the Code, to the extent

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of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of a personal residence within the meaning of section 1034 of the Code, personal property, stock in trade, or other property held primarily for sale.

In *Crichton v. Commissioner*, 42 BTA 490 (1940), a taxpayer and her children owned undivided interests in unimproved country land and also an unimproved city lot. The children transferred to the taxpayer their undivided interest in the city lot in exchange for the taxpayer's transferring to them her undivided interest as to oil, gas, and other minerals, in, on, and under the country land. This exchange qualified for nonrecognition treatment under Section 1031.

c. The Holding Requirement. Although there is no specific duration required to meet the holding requirement, the IRS generally takes the view that Relinquished Property acquired immediately before a like-kind exchange or Replacement Property only held for a short time after a like-kind exchange was not held by a taxpayer for use in a trade or business or as an investment, but rather a re-sale intention. In Rev. Rul. 75-292, 1975-2 C.B. 333, the IRS held that a like-kind exchange followed by the contribution of the taxpayer's property into a corporation was disqualified under Section 1031. The IRS reasoned that the taxpayer failed to hold the property for investment purposes since he immediately contributed the property into a wholly-owned corporation following the like-kind exchange. It is uncertain how long Replacement Property must be held by the taxpayer to prove that real estate has been held for trade or business, or for investment. A prior legislative proposal would have created a "bright line" test where the Replacement Property would need to be held for at least one year. Although this proposal was never enacted, many practitioners believe that the holding period should be at least 18 months, or in unusual cases in which a shorter period can be justified, at least 12 months.

i. Swap and Drop. In a "Swap and Drop" type of transaction, the taxpayer exchanges assets and then soon after contributes those assets into an existing or newly formed partnership or corporation. The issues are whether the "held for" requirement is met after the exchange or whether the exchange was really for the corporate stock or partnership interest the taxpayer receives after dropping the real property into the entity, both of which are not considered "like-kind" property. In Rev. Rul. 75-292, the IRS held that the transfer of property acquired in a Section 1031 like-kind exchange to a wholly owned corporation violated the "held for" requirement. Even though the transaction was tax-free under Section 351, the IRS refused to continue the "held for" period as an investment in the newly formed corporation. The Tax Court disagreed and the Ninth Circuit in *Magneson v. Commissioner* affirmed the Tax Court holding that the transfer of replacement property immediately into a partnership did not violate Section 1031. *Magneson v. Comm'r*, 753 F.2d 1490 (9th Cir. 1985). The Ninth Circuit wrote that "…for tax purposes, joint ownership of the property and partnership ownership of the property are merely formal differences and not substantial differences." However, it is unsettled what the courts would do if the IRS would have argued that, under the "step-transaction" doctrine, the transaction was not for like-kind property and instead for a partnership interest. Because there is no clear guidance on the issues, taxpayers should be aware that such transactions will be subject to a greater level of scrutiny by the IRS, and taxpayers should realize that the IRS is likely to challenge a Swap and Drop transaction due to the fact that the IRS can challenge both the "holding" and "like-kind" requirements. Note that swapping or dropping to an LLC or other disregarded entity for federal tax purposes will not affect the holding period of the exchange assets. When exchange property is held in a disregarded entity, the entity is ignored for purposes of Section 1031. *See* Rev. Proc. 2000-37, 2000-2 C.B. 308.

ii. Drop and Swap. In this transaction, the taxpayer drops down assets from an existing partnership or corporation and then immediately exchanges the property. The issue is whether the "holding" requirement is met prior to the exchange. The IRS has held that a taxpayer who drops property down does not meet the "holding" requirement. *See* Rev. Rul. 75-291, 1975-2 CB 332; *See also* Rev. Rul. 77-297, 1972-2 CB 304. In Rev. Rul. 77-337, 1977-2, CB 305, the IRS held that where a taxpayer liquidated a wholly-owned corporation and then exchanged some of the assets immediately after the liquidation, the exchange violated the "held for" requirement before the exchange. However, in *Bolker v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985), the Ninth Circuit, affirming the Tax Court, held that if a taxpayer owns property which he does not intend to liquidate or use for personal pursuits, he is holding the property "for productive use in trade or business or for investment" within the meaning of Section 1031(a).3 Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement because it is not an intent to liquidate the investment or to use it for personal pursuits. Accordingly, the taxpayer was allowed like-kind exchange treatment after having liquidated a wholly-owned corporation. Despite the Tax Court's and the Ninth Circuit's rejection of the IRS's position with respect to drop and swap transactions, planners and taxpayers must be aware that any transaction structured in this manner could be subject to additional scrutiny and attack by the IRS, even though the IRS may only be able to argue that the holding requirement was not met, rather than arguing that both the like-kind requirement and the holding requirement were violated. Note that swapping or dropping to an LLC or other disregarded entity for federal tax purposes will not affect the holding period of the exchange assets. When exchange property is held in a disregarded entity, the entity is ignored for purposes of Section 1031. *See* Rev. Proc. 2000-37, 2000-2 C.B. 308.

iii. Disregarded Entities. The IRS has freely permitted the use of disregarded entities in structuring like-exchanges without asserting that such use violates the holding requirement. In PLR 200118023, the taxpayer desired to acquire certain Replacement Property but the transfer of property would be subject to a real estate transfer fee. The real property was held in a single member LLC. The IRS ruled that the transfer of membership interest issued the single member LLC that owned the Replacement Property in exchange for the Relinquished Property satisfied the requirements under Section 1031.

iv. Converting Qualified Purpose Property. "A taxpayer's intent to hold a property for productive use in a trade or business or for investment is a question of fact that must be determined at the time of the exchange." *See Reesink v. Comm'r*, T.C. Memo 2012-118; *see also Yates v. Comm'r*, T.C. Memo 2013-28. A subsequent conversion to a personal residence or vacation home should not prevent the taxpayer from satisfying the qualifying use requirement provided the taxpayer did not have the intention to convert the property to personal use at the time of the exchange. *Id*. In *Reesink*, the Tax Court upheld the validity of a section 1031 like-kind exchange

3 753 F.2d 1490 (9th Cir. 1985).

by noting that the taxpayers' efforts to rent the home, including placing flyers in nearby areas and showing the property to potential renters, demonstrated their intent to hold the property for business purposes. The Tax Court came to such a conclusion notwithstanding the fact that the taxpayers moved into the home eight months after the exchange. However, in *Yates*, the Tax Court noted that taxpayers' failure to submit any evidence into the record regarding their efforts to transform their property into a business enterprise underscores their lack of business motive in the exchange. Furthermore, the Court wrote that taxpayers' use of the property as their personal residence, beginning a mere four days following the close of the sale, created a clear presumption of nonbusiness intent, exceeding that of the taxpayers in *Reesink*.

Rev. Proc. 2008-16 provides a safe harbor for determining how long a Replacement Property must be held as a rental prior to converting it to a primary residence or vacation home without invalidating the prior exchange. Under the safe harbor, a dwelling unit qualifies as Replacement Property in an exchange if it is owned by the taxpayer for at least twenty-four (24) months immediately after the exchange, and, in each of the two twelve (12) month periods: (i) the taxpayer rents the Replacement Property to another person or persons at a fair rental for fourteen (14) days or more; and (ii) the taxpayer's personal use of the Replacement Property does not exceed the greater of fourteen (14) days or 10% of the number of days during the twelve (12) month period that the dwelling unit is rented at a fare rental.

2. Deferred Like-Kind Exchanges. Often times, a taxpayer is focused on the sale of the Replacement Property and has not had a chance to locate sufficient Replacement Property. A deferred like-kind exchange allows the taxpayer to locate and designate Replacement Property to complete the exchange after the Relinquished Property is sold. The IRS has established safe harbor guidelines that, if followed, will result in a successful deferred like-kind exchange. A deferred like-kind exchange that does not satisfy the safe harbor rules may qualify under the like-kind exchange rules established by case law precedent. Reg. § 1.1031(k)-1 provides guidance on deferred exchanges. According to the safe harbor rules, real estate can be acquired after the sale of relinquished property, provided the following two (2) deadlines are met:

a. 45-Day Rule. The seller must identify the target Replacement Property no later than forty-five (45) days after the closing date of the sale of relinquished property. Reg. § 1.1031(k)-1. Reg. § 1.1031(k)-1(b)(2)(iii). During this "identification period", the seller may identify multiple parcels of replacement property if the identification satisfies either of the following tests:

i. Three-property test. Under this test, the seller may identify any three (3) properties without regard to their fair market value. Reg. § 1.1031(k)-1(c)(4).

ii. 200% test. Under this test, the taxpayer may identify any number of properties as long as the aggregate fair market values of the identified properties do not exceed 200% of the aggregate fair market values of all the relinquished properties as of the closing date. Reg. § 1.1031(k)-1(e)(2)(ii).

b. 180-Day Rule. The seller must close on the Replacement Property during the "exchange period" which is the *earlier* of (i) 180 days after the Relinquished Property is sold, or (ii) the due date of the seller's tax return for the year in which the seller transfers the relinquished property to the acquirer. Reg. § 1.1031(k)-1. *See Christen v. Commissioner*, T.C. Memo 1996-254, *aff'd in an unpublished opinion* (9th Cir. 1998) where a taxpayer inadvertently shortened the 180-day period and caused a like-kind exchange to fail by filing a tax return on April 15. Note that this rule is expressed in the terms of days, and not months. The parties to the exchange should count the actual number of days after the initial sale of the Relinquished Property. If the taxpayer transfers multiple properties pursuant to the same deferred exchange and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date to which any of the properties are transferred.

3. Qualified Intermediaries. Reg. § 1.1031(k)-1(g) provides for "safe harbor" techniques to avoid both the actual or constructive receipt of money (resulting in a fully and presently taxable transfer) for purposes of Section 1031. Note that the safe harbors do not apply if the taxpayer has the ability or unrestricted right to receive money or other property before the taxpayer actually receives like-kind replacement property. One of the more common safe harbor techniques is the use of a "qualified intermediary" or "QI". In general, pursuant to Reg. § 1.1031(k)-1(g)(4), a QI is not considered an agent of the taxpayer for purposes of Section1031(a). This safe harbor applies only if the taxpayer and the QI execute an exchange agreement which expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. A QI is generally a person or entity (other than the taxpayer) who, for a fee, acts to facilitate the deferred exchange. Under the exchange agreement, the QI agrees to receive the Relinquished Property from the taxpayer, acquire the Replacement Property with the proceeds of the Relinquished Property, and then transfer the Replacement Property to the taxpayer. Reg. § 1.1031(k)-1(g)(4)(iv) provides that a QI will be treated as properly acquiring and transferring property if the QI: (1) transfers legal title to the property; (2) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and pursuant to that agreement, the relinquished property is transferred to that person; and (3) enters into an agreement with the owner of the replacement property for the transfer of that property and pursuant to that agreement, the replacement property is transferred to the taxpayer. A taxpayer may enter into a purchase agreement for the transfer of the Relinquished Property and thereafter notify, in writing, all parties of the assignment of the purchase agreement to the QI. See Reg. § 1.1031(k)-1(g)(4)(v). This is a very common structure of a like-kind exchange transaction.

4. Reverse Exchanges. In a deferred like-kind exchange, the taxpayer finds the Replacement Property after it sells the Relinquished Property. Suppose the order of events is reversed, and the taxpayer identifies the Replacement Property before completing the sale of the Relinquished Property. Rev. Proc. 2000-37, 40 I.RB 308, provides a safe harbor for this "parking-style" exchange and allows an accommodation titleholder ("AT") to acquire either the Relinquished Property or the Replacement Property in an exchange and hold it for up to 180-days while the taxpayer sells the Relinquished Property. Under Rev. Proc. 2000-37, the IRS will not challenge: (i) the qualification of property as either Replacement Property or Relinquished Property in an exchange; or (ii) the treatment of an AT as the beneficial owner of such property if the property is

held pursuant to a qualified exchange accommodation ("QEA") arrangement. See Rev. Proc. 2000-37 for more detail regarding reverse exchanges and QEA arrangements.

5. Taxable "Boot". Assuming all other provisions of a like-kind exchange are met, the like-kind exchange will be tax-free except to the extent the seller receives "boot" along with the like-kind property. Section 1031(b). "Boot" refers to any taxable money or non-like-kind property received. If boot is received, taxpayer will be taxed on the gain inherent in the property disposed to the extent of the value of the boot.

a. Spotting Boot. The properties in a like-kind exchange frequently differ either in (1) their fair market values or (2) the amount of debt by which they are encumbered. If this occurs, at least one party to the exchange is deemed to receive boot either because (1) the party is receiving more value than is being given up, or (2) the party is being relieved of more debt on the Relinquished Property than the party is assuming on the Replacement Property. For purposes of computing any gain recognition with respect to the like-kind property, a transferor is deemed to have received cash boot to the extent (if any) that the amount of debt (assumed or taken subject to) with respect to the Relinquished Property exceeds the amount of the debt to be assumed or taken subject to or in respect to the Replacement Property. In other words, any net decrease in the property-related debt is also deemed to be taxable boot. Reg. § 1.1031(d)-2.

b. Reducing/Eliminating Boot. Rev. Rul. 72-456, 1972-2 C.B. 468, provides that certain expenses of the transaction, such as brokerage commissions, reduce the amount of consideration received in a Section 1031 exchange and increases the basis of the exchange property. General Counsel Memorandum ("GCM") 34895 (June 5, 1972) suggests a broad application of the ruling and that all expenses "incurred in connection with the exchange" should offset boot. Transaction expenses which should offset boot include (i) subdivision, improvement district or quasi-governmental assessments; (ii) survey costs; (iii) environmental assessment costs; (iv) appraisal costs; and (v) engineering costs. It is not clear whether syndication-"type" costs, such as printing costs, photographs and legal fees for securities law matters, which are often necessitated by a like-kind exchange would offset boot. In *Blatt v. Commissioner*, the Tax Court stated that "the amount of boot received is decreased by the taxpayer's exchange expenses." 458 T.C. Memo 1994-48. The government's brief in *Blatt* conceded that the following expenses were allowed or disallowed as "exchange expenses": Escrow Fees; Obtaining Lender Statement; Document Preparation; Title Insurance Policy; Sub-Title Fee; Exchange Tie-in Fee; Recording Grant Deed; Recording Reconveyance; Document Transfer Tax; Statement Fee; Reconveyance Fee; Loan Organization Fee; Document Preparation; Tax Service; Processing Fee; Messenger Fee; Lenders Title Policy Premium; Sub-Escrow Fee; Record Grant Deed; Record Trust Deed; and Loan Tie-In Fee.

6. Ownership by Tenants-in-Common. Like-kind exchanges are also possible if there are multiple owners of the Relinquished Property. Each owner is considered a tenant-in-common or a "TIC". In Rev. Proc. 2002-22, 2002-14 IRB 733, the IRS issued significant guidance concerning whether an undivided fractional interest or TIC interest in real estate will be treated as giving rise to a separate business entity (partnership) for federal income tax purposes. Section 6.02 of Rev. Proc. 2002-22 provides that "[e]ach of the co-owners must hold title to the [p]roperty (either

directly or through a disregarded entity) as a tenant-in-common under local law. Thus, title to the [p]roperty as a whole may not be held by an entity recognized under local law." Additionally, the number of co-owners is limited to 35 persons. Rev. Proc. 2002-22 specifically endorses the use of disregarded entities to hold title to the TIC interests. This provision is critical because each of the co-owners frequently will be required by the other co-owners (or the sponsor) to place his or her TIC interest into a disregarded entity in order to avoid legal risks arising from the death or bankruptcy of a co-owner.

a. Co-Ownership Agreement. Under § 6.04 of Rev. Proc. 2002-22, the co-owners may enter into a limited ownership agreement that runs with the land. This ownership agreement may contain a mechanism to enforce the other rights and privileges of the co-owners that are permissible under Rev. Proc. 2002-22, such as a right of first offer. Rev. Proc. 2002-22 does not specifically allow a right of first refusal, however it would seem to be permissible. In general, § 6.06 of Rev. Proc. 2002-22 requires that each co-owner must have the right to transfer, partition, and encumber the co-owner's TIC interest in the property without the agreement or approval of any person (although a right of first offer, and likely a right of first refusal, is allowed). However, restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited.

b. Sharing Proceeds and Liabilities on Sale. Under § 6.07 of Rev. Proc. 2002-22, if the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. This provision prevents the retention of profit or debt by one of the co-owners on the sale of the property, which would be indicative of a partnership (through the non-pro-rata sharing of profits and liabilities). Under § 6.08 of Rev. Proc. 2002-22, each co-owner must share in all revenue generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property. In addition, neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner and is not for a period exceeding 31 days.

7. Build-to-Suits. The IRS and the courts have approved transactions in which (i) one party (the "Constructing Exchanger") acquired land or a ground lease from an unrelated party, (ii) the Constructing Exchanger then constructed certain improvements on that land desired by another unrelated party (the "Acquiring Party"), and (iii) then the Acquiring Party then exchanged like-kind exchange funds with the Constructing Exchanger for the land (or ground lease) and improvements. *See J.H. Baird Publishing Co.*, 39 T.C. 608; Rev. Rul. 75-291, 1975-2 CB 332. In this regard, note that the improvements must be identifiable as contemplated above. Further, to achieve this result, the Acquiring Party had to have sufficient benefits and burdens of ownership of the land (or ground lease) and bear construction period risks. Otherwise, the Acquiring Party could be viewed by the IRS as the taxpayer's agent, in which case the improvements would be deemed to be constructed on land already owned by the taxpayer under the rationale of *Bloomington Coca-Cola Bottling Company*, 189 F.2d 14 (1951). In PLR 200251008, the IRS held that the reverse like-kind exchange safe harbor included in Rev. Proc. 2000-37 permitted a taxpayer to use like-kind exchange proceeds from a sale of appreciated real estate to construct a building on land owned by a related party. *See also*, Build-To-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment,

Journal of Taxation (January 2003), Borden, Lederman and Spear. However, Rev. Proc. 2004-51, 2004-33 I.R.B. 294 (7/20/04), *modifying* Rev. Proc. 2000-37, 2000-40 C.B. 308, provided that the safe harbor provision of Rev. Proc. 2000-37 does not apply to reverse like-kind "parking" arrangements if the taxpayer owns the property intended to qualify as replacement property within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder.

a. PLR 201408019**.** In a Private Letter Ruling, the IRS approved the taxpayer's use of a Qualified Intermediary and Qualified Exchange Trust to build the taxpayer's replacement property through the taxpayer's use of two different entities, one which owned the replacement property and another which leased it, both entities were related to the taxpayer. The taxpayer provided the following facts: The taxpayer was an LLC, treated as a partnership for Federal tax purposes and indirectly owned (through a wholly owned subsidiary LLC and REIT) by a limited partnership ("LP"). Pursuant to Section 1031(f)(3), the taxpayer and LP are related entities. The taxpayer entered into an agreement to sell its relinquished property to an unrelated third party. Taxpayer then assigned its sale agreement to a qualified intermediary under an exchange agreement. The replacement property is an old building owned by an LLC, which is disregarded for Federal tax purposes and partially owned by LP. The replacement property owner has leased the replacement property to a second LLC, which is disregarded and wholly owned by LP. The lessee LLC will sublease the building to an exchange accommodation titleholder (EAT), which will proceed to demolish it and build the replacement property. The taxpayer will then assign to the qualified intermediary its rights to acquire the replacement property. On or before the 180th day from the sublease, EAT will transfer the replacement property to the taxpayer. The IRS held that Section 1031(f)(1) would not apply because of the taxpayer's use of a qualified intermediary, and Section 1031(f)(4) would not apply because none of the taxpayer's related parties would receive cash in exchange for their interests within two years of the transaction.

8. Construction/Improvements on Parked Replacement Property. Improvements may also be made to the replacement property under a QEA agreement. Rev. Proc. 2000-37 provides that the taxpayer or a disqualified person may supervise the improvement of the parked property or act as a contractor for the improvements. In such circumstances, the taxpayer will need to arrange a construction loan, guarantee or otherwise provide funding for the improvements. The AT may enter into a construction contract and appoint the taxpayer as agent to handle all supervision and draws. If the relinquished property sells during the construction of the improvements, the taxpayer must identify the improvements by the end of the 45-day identification period contained in Reg. 1.1031(k)-1(c). Note that the commitment fees paid by the taxpayer to secure the construction financing is considered an indirect cost of the property and may be included in the taxpayer's accumulated expenditures under Reg. § 1.263A-11. See CCA 201136022.

C. Installment Sales. Taxpayers are usually taxed in the year real estate is sold on the value of the amount received for the real estate. Like-kind exchanges are an exception to this general rule. Installment sales are another exception to this general rule. Gains (but not losses) on installment sales are deferred under Section 453. An "installment sale" is defined as a disposition where at least one (1) payment occurs after the taxable year of disposition.

1. Eligibility. In general, the installment sale method for reporting gain is not available if the sale is a "dealer disposition," which is defined to include the sale of real property held for sale to customers in the ordinary course of business. Section 453(l)(1). However, there are some limited exceptions to dealer disposition treatment under Section 453(1)(2). These exceptions apply to sales of property used or produced in the trade or business of farming and timeshares and residential lots. "Timeshares and residential lots" means (i) residential lots that the taxpayer does not improve; (ii) timeshares in residential real property for not more than six weeks per year; and (iii) rights to use specific campgrounds for recreational purposes. To qualify for these exceptions, the sales must be made in the ordinary course of the taxpayer's business, every buyer must be an individual, and installment obligations must not be guaranteed by anyone other than an individual.

2. Interest Charge on Deferred Tax. Taxpayers making dealer dispositions of "timeshares or residential lots" who are permitted to use the installment sale method under the exception discussed above must pay interest on the deferred tax at the applicable federal rate under Section 1274 from the date of sale on the amount of tax inherent in payments received in future years. A similar rule generally applies interest under the Section 6621 rate to any other non-dealer installment sale if installment obligations from dispositions by the taxpayer during the tax year which are still outstanding at the close of the tax year exceed $5,000,000. See Section 453A(b). However, the interest charge does not apply to installment obligations arising from the disposition of property used or produced for farming, as defined in Sections 2032A(e)(4), (5). The application of the interest charge is unclear if the installment obligation provides for contingent payments. The IRS has yet to issue regulations dealing with contingent payments in installment sales. For example, an installment note might provide for five annual payments of one million dollars, as well as a contingent payment in the final year calculated as a multiple of the property's rental value. In this case, it is not clear what method the taxpayer should use for calculating the value of the contingent payment (and thus the amount of the interest charge), or whether the taxpayer will have any relief if the contingent payment is less than expected.

3. Recapture. In the case of an installment sale, any recapture income shall be recognized in the year of the disposition, and gain in excess of the recapture income shall be taken into account under the installment method. Section § 453(i)(1). "Recapture income" means, with respect to any installment sale, the aggregate amount which would be treated as ordinary income under Sections 1245 or 1250 (or so much of Section 751 as relates to Section 1245 or 1250) for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition. Section § 453(i)(2).

4. Electing Out of the Installment Sale Method. It is possible for taxpayers to elect out of the installment method of reporting gain. Section 453(d)(1). The election must be made on or before the due date (including extensions) of the taxpayer's return for the taxable year of the disposition. Section 453(d)(2). Once made, an election out of the installment method is revocable only with the consent of the IRS. Section 453(d)(3). This may be advisable in the case where a taxpayer has significant capital losses which could offset all of the capital gain inherent in the real estate sold. If the installment method is not available or the taxpayer elects out of installment treatment, all of the gain is reported in the year of disposition.

5. Computing the Annual Gain Subject to Tax. Where the installment method applies to an installment sale, the amount of gain to be included as income for any given taxable year is an amount equal to all of the principal payments received during the year multiplied by the gross profit percentage. Section 453(c). The gross profit percentage is the gross profit divided by the total selling price. In other words, the total gain is allocated among taxable years proportionately to the amount of principal payments received in the various years. Gross profit is the selling price (total amount realized at the face amount) reduced by (i) selling commissions, (ii) other expenses of sale, (iii) the adjusted basis at the time of disposition, and (iv) any depreciation "recapture" income. Reg. § 15A.453-1(b)(2)(v). Depreciation recapture income cannot come under the installment sale method and is fully taxable in the year of disposition (but only to the extent of the gain inherent in the real estate sold). In determining the amount of gain taxable in each installment sale payment, remember that this only relates to the principal amount of the installment payment and does not include interest paid on the principal. Interest is includible in income separately by the seller as it is received or accrued (depending on the seller's tax accounting method).

a. Example: John sells real estate having a basis of $30,000 to Bruce for $100,000. The $100,000 purchase price is paid by a $20,000 cash down payment and four future principal payments of $20,000, plus interest at 10%. The selling expenses are $10,000. The gross profit is as follows:

Selling Price:	$100,000
Adjusted basis:	($ 30,000)
Expenses of the Sale	($ 10,000)
Gross Profit:	$ 60,000

Therefore, the gross profit percentage is 60% ($60,000 ÷ $100,000). Accordingly, $12,000 of the $20,000 down payment is treated as taxable gain ($20,000 x 60%= $12,000), while $8,000 is treated as recovery of basis. Subsequent installments of principal will likewise be multiplied by the gross profit percentage to determine the amount includible in income. Note that selling expenses reduce gain, but not payments or contract price. Also, note that interest is considered separately. Under various provisions of the Code, it may be necessary to "impute" interest where the interest rate charged on the installment obligation is lower than the IRS prescribed rate. When interest is imputed, the taxpayer will need to recalculate (reduce) the principal and (increase) the interest components in installment obligations.

6. Effect of Mortgages. If a purchaser assumes or takes real property subject to a mortgage, the mortgage is included in the amount realized for purposes of computing "gross profit". However, the amount of the mortgage is not included in the "payment" for the year of disposition, except to the extent the mortgage exceeds the seller's adjusted basis in the property (increased by selling expenses). *Joe Kelly Butler Inc. v. Commissioner,* 87 T.C. 734 (1986). If the mortgage exceeds the seller's adjusted basis, the taxpayer will be treated as having received a payment in the year of sale which includes both cash received and the amount by which the mortgage on the real estate exceeds the seller's basis in the real estate. This is likely to be a tax result that was not anticipated by the seller.

a. Example: John needs $32,000 to start a production company so he decided to sell certain real estate to Bruce. The real estate is worth $100,000, encumbered by a mortgage of $60,000 and John has a basis in the real estate of $50,000. The terms of the sale require a $35,000 cash down payment and John will carry back a second mortgage for $15,000. The gross profit on the sale is $50,000 ($100,000 minus $50,000 basis). Because the contract price for the real estate is $100,000 and his basis is $50,000, John knew that the ratio of his gross profit to contract price was ½ (or 50%). Therefore, he was expecting to pay a tax on a capital gain equal to one-half of the $35,000 cash down payment or $17,500. At a 20% capital gain tax rate, this means John would pay a tax of $3,500 (20% x 17,500). With a tax owing of only $3,500, John would have enough money left from the $35,000 cash down payment to make his $32,000 investment in the production company. Unfortunately, however, John is in for a surprise. Because the $60,000 debt encumbering the real estate exceeds John's $50,000 basis by $10,000, the amount of the gain which will be taxable in the year of sale will be one-half of $45,000 (the $35,000 cash down payment plus the $10,000 of debt in excess of basis) or $22,500. At a 20% capital gain tax rate, this means John will owe tax of $4,500, so he will not have enough funds left over from the cash down payment to invest in the production company.

7. Post-Closing Triggers of Taxation.

a. Pledging Rules. If the sales price for real estate from a non-dealer sale exceeds $150,000, any borrowing of money by the seller secured by the installment obligation (received from the sale of the real estate) will result in the loan proceeds being treated as taxable "payments" on the obligation in the year of borrowing. Section 453A(d). (There is a mechanism to prevent the same amounts from being taxed again when received from the purchaser.) This rule does not apply to installment sales of farm property.

b. Disposition of Installment Obligation. In general, any disposition of any installment obligation by the seller (other than by death) triggers gain or loss to the seller equal to the excess of (i) the amount realized in a sale or exchange (or, if no sale or exchange, the fair market value of such obligation) over (ii) the seller's basis in the installment obligation. Section 453B. When an installment obligation is transferred by reason of the death of the holder, the transfer is not a taxable disposition for federal income tax purposes, and no income is reportable in the decedent's final return. Section 453B(c). Any unrecognized gain attributable to the installment obligation is an item of income in respect of a decedent ("IRD") that is recognized as payments are received by the decedent's estate. Section 691(a).

i. The IRS has issued proposed regulations which would expand the circumstances in which a disposition of an installment obligation is deemed to have occurred (thereby resulting in immediate recognition of any deferred gain inherent in that installment obligation). Proposed Reg. section 1.453B-1. Under these proposed regulations, a disposition of an installment obligation would additionally include (i) partnership distributions of installment obligations contributed to the partnership within the preceding seven years (per Code Section 704[c][1][B]), (ii) receipt of a partnership interest in satisfaction of an installment obligation, and (iii) recognition of pre-contribution gain in the case of certain distributions to a contributing partner (per Code Section 737).

8. Alternative Minimum Tax. Sales reported under the installment method for regular tax purposes may also be reported under the installment method for alternative minimum tax purposes. *William G. Loomis v. Commissioner*, T.C. Memo 1997-381 (1997). A prohibition on the use of the installment method for alternative minimum tax purposes was retroactively repealed by the Taxpayer Relief Act of 1997. Section 403(b), P.L. 105-34 (8/5/97).

D. Lease Agreements

1. Rev. Rul. 55-540. Whenever certain characteristics of a transaction – such as an option to purchase – are coupled with a real estate lease, a tax question arises as to whether the sale will be deemed to have occurred before the option is exercised. Facts and circumstances suggesting that the "lessor" is parting with ownership may suggest that the transaction should be characterized as an installment sale rather than a lease. This issue is addressed by analyzing the terms of the lease to determine whether, based on all of the facts and circumstances, the lease effectively transfers to the tenant virtually all of the benefits and burdens of owning the leased real estate. In Rev. Rul. 55-540, 1955-2 C.B. 39, the IRS set out a series of guidelines on the sale versus lease issue. Rev. Rul. 55-540 states that in the absence of compelling persuasive factors of contrary implication, an intent, warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement, may in general be said to exist if, for example, one or more of the following conditions are present:

a. Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.

b. The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make.

c. The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.

d. The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.

e. The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared to the total payments which are required to be made.

f. Some portion of the periodic payments is specifically designated as interest or otherwise readily recognizable as the equivalent of interest. Rev. Rul. 55-540, § 4.

2. Triple Net Lease with Purchase Option. The classic example of a sale versus lease issue involves a triple net lease which grants the tenant the option to purchase the leased real

estate at fixed price in the future, where the rentals paid apply, either expressly or tacitly, toward purchase and/or the future fixed price will likely be below fair market value. From a tenant's point of view, re-characterization of a lease as an installment sale means that all rent deductions will be disallowed, and the tenant will be treated as if the tenant had been the owner of the real estate from the inception of the lease, and the purported "rent" will be regarded as installments in reduction of the purchase price and not deductible. However, the tenant may be entitled to imputed interest and depreciation deductions. The landlord will be treated as having sold the real estate and may be entitled to report any gain as an installment sale.

3. Leveraged Lease. The analysis becomes more complicated when dealing with a leveraged lease – where a leasing transaction is financed with borrowed money. Many leveraged lease transactions involve a sale-leaseback arrangement. An issue which may arise is whether the owner-lessor is the true owner of the property or merely a provider of financing to the lessee, who should be treated as the true owner. It should be noted, however, that the basic principles applicable to a leveraged lease transaction are similar to those applicable to a non-financed lease – i.e., does the owner-lessor possess sufficient benefits and burdens of ownership to be treated as the true owner for federal tax purposes? The IRS set out advance ruling guidelines with respect to leveraged leases in Rev. Proc. 2001-28, 2001-1 C.B. 1156. Rev. Proc. 2001-28 provides that, unless other facts and circumstances indicate a contrary intent, for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the true owner of the property and the transaction a valid lease if all of the guidelines described below are met:

a. The lessor must make an initial minimum unconditional "at risk" investment in the property of 20% of its cost.

b. The minimum investment must remain at least 20% of the property's cost at all times throughout the lease term.

c. The lessor must represent and demonstrate that the property's fair market value at the conclusion of the lease is reasonably expected to be at least 20% of original cost.

d. In general, no part of the cost of the property or any improvement, modification, or addition to the property may be furnished by a member of the lessee group. The lessee group consists of the lessee, shareholders of the lessee, persons whose stock ownership would be attributed to the lessee under Section 318, and persons who would constructively own (under Section 318) stock owned by the lessee.

e. No member of the lessee's group may lend funds to the lessor to finance the property's acquisition or guarantee any of the lessor's acquisition indebtedness.

f. The lessor must represent and demonstrate that the property's useful life at the conclusion of the lease term may reasonably be expected to be at least 20% of the originally estimated useful life, or if longer, one year.

g. The lessee's group may not have a contractual right to purchase the property from the lessor for less than its fair market value when the right is exercised.

h. When the lessee first places the property in service, the lessor may not have a contractual right to cause any party to purchase the property, and the lessor must represent that it has no present intention to acquire such a contractual right.

i. The lessor must establish that it expects profits from the transaction, aside from tax benefits.

For purposes of these advance ruling guidelines, the lease term is deemed to include all renewal or extension periods, except renewals or extension periods at the option of the lessee at fair rental value at the time of renewal or extension. Rev. Proc. 2001-28.

VIII. INBOUND FOREIGN INVESTMENT.

A. Taxation of Non-US Persons. The Code generally subjects the worldwide income of all U.S. persons to tax. See Sections 1, 11, 61, 7701(a)(1). Non-US persons are generally only subject to U.S. taxes on (a) U.S.-sourced fixed determinable annual or periodical income and (b) income that is (or is treated as) effectively connected with a U.S. trade or business ("ECI"). Sections 2(d), 11(d), 871, 881, 882 and 1441. The Code and regulations provide rules for determining the source of income for this purpose. See Sections 861-863, 865. For most purposes, capital gain income is sourced to the residence of the seller. As a result, most capital gains earned by foreign persons are foreign sourced and not subject to U.S. income tax (assuming such capital gains are not part of ECI). Foreign persons generally do not pay U.S. tax on dispositions of securities or personal property located in the United States. However, since the enactment of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), this tax treatment has not applied to dispositions of real property interests located in the United States.

1. Sales of U.S. Real Property Interests. Although foreign persons are not subject to U.S. income tax on most capital gains derived from U.S. sources, they are subject to U.S. income tax on gains resulting from the sale of a "U.S. real property interest" ("USRPI"). Prior to FIRPTA, gains realized from the disposition of certain USRPI (including U.S. oil and gas interests) by a foreign investor were treated as capital gains and generally not subject to U.S. taxation (unless otherwise considered ECI). Under these rules, foreign investors could plan and structure investments and subsequent dispositions in USRPI without being subject to US taxes. Under the rules enacted by FIRPTA, gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a USRPI is treated as if the foreign investor were engaged in a trade or business in the United States and as if such gain or loss were effectively connected with that trade or business. Section 897(a)(1). This treatment applies regardless of whether the foreign investor is actually engaged in business in the U.S. or whether the income is effectively connected with a trade or business. A look-through approach brings indirect ownership of a USRPI within the reach of these rules by treating a USRPI held by a partnership, trust, or estate as owned proportionately by the partners or beneficiaries. Section 897(g). While gain from the sale of stock in a foreign corporation will not be taxed, the foreign corporation is taxed if and when it distributes its USRPI to its shareholders.

a. USPRI Defined. Section 1445's withholding requirement generally applies to any transaction involving sales of fee interests in non-residential real estate or residential real estate to a foreign investor. It is also important to note that this withholding obligation can arise for a variety of transactions in addition to routine sales of real estate. It can also apply in respect to (i) the sale of personal property closely associated with real estate (such as moveable walls, partitions and furnishings), and (ii) in some instances, the sale of stock in a U.S. corporation if 50% or more of the fair market value of the corporation's assets are U.S. real property. Section 897(c)(2).

2. Withholding Requirement. To ensure enforcement of FIRPTA, Section 1445(a) generally imposes the withholding requirement on the buyer in a transaction with includes a USPRI. The buyer is generally required to withhold ten percent (10%) of the amount realized upon the sale of any USPRI. It should be noted that, upon dispositions of USRPIs by domestic partnerships with foreign partners and distributions of USRPIs by foreign corporations, withholding may be required with respect to a percentage of the partnership's or corporation's gain, rather than the amount realized. This result may, depending on the circumstances, produce a greater or lower withholding requirement than the general 10% rule. Sections 1445(e)(1)-(2). The amount realized includes cash, the fair market value of non-cash property to be given by the purchaser, and the outstanding balance of any liabilities assumed by the buyer. Reg. § 1.1445-1(g)(5). If the consideration that the buyer pays in liquid assets (i.e., cash) does not satisfy the withholding obligation (such as in an installment sale transaction), the buyer can request a "withholding certificate" from the IRS authorizing a lower withholding amount. Reg. § 1.1445-3.

3. Foreign Person Defined. Section 1445 withholding requirements apply if the real estate is transferred by a "foreign person", which includes a non-resident alien, foreign corporation, foreign partnership, foreign trust or foreign estate. Reg. § 1.1445-2(b)(2).

4. Who Must Withhold. Sections 1441(a) and 1442 provide that "all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment" or various items of U.S. source income of a nonresident alien individual, foreign partnership or foreign corporation must withhold. A "withholding agent" is generally the buyer in the real estate transaction and is broadly construed to include individuals, a corporations, a partnerships, limited liability companies, other entities or a fiduciary.

5. Failure to Withhold. If the buyer fails to collect the required withholding amount from a foreign person, the buyer will be held liable for the payment of the withholding amount plus additional penalties.

6. Exceptions From Withholding. The buyer in a transaction involving the sale of USPRI does not need to withhold the 10% tax if any of the following apply:

a. The buyer acquires the property for use as a home and the amount realized (generally sales price) is not more than $300,000; provided, however, that the buyer or members of the buyer's family must have definite plans to reside at the property for at least 50% of the number of days the property is used by any person during each of the first two 12-month periods following the date of transfer. When counting the number of days the property is used, days the property will be vacant should not be counted.

b. The property disposed of is an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market; provided, however, that if the class of stock had been held by a foreign person who beneficially owned more than 5% of the fair market value of that class at any time during the previous 5-year period, then that interest is a USPRI if the corporation qualifies as a United States Real Property Holding Corporation ("USRPHC") and the buyer must withhold upon on any disposition.

c. The disposition is of an interest in a domestic corporation which furnishes a certification stating, under penalties of perjury, that the interest is not a USPRI. Generally, the corporation can make this certification only if the corporation was not a USRPHC during the previous 5 years, or as of the date of disposition, the interest in the corporation is not a USRPI by reason of Section 897(c)(1)(B) of the Internal Revenue Code. Note that the certification must be dated not more than 30 days before the date of transfer.

d. The seller provides a certification stating, under penalties of perjury, that the seller is not a foreign person (or a disregarded entity) and containing the seller's name, U.S. taxpayer identification number, and home address (or office address, in the case of an entity). Note that in most real estate transactions, the buyer's legal counsel will require this "certificate of non-foreign status" as a closing deliverable.

e. The buyer receives one of the following withholding certificates from the IRS. Generally, the seller, the seller's agent, or the buyer may request a withholding certificate. The IRS will generally respond to these requests within 90 days after receiving a completed application for the transaction. A seller that applies for a withholding certificate must notify the buyer in writing that the certificate has been applied for on the day of or the day prior to the transfer.

i. Applications based on a claim that the transfer is entitled to non-recognition treatment or is exempt from tax,

ii. Applications based solely on a calculation of the transferor's maximum tax liability,

iii. Applications under special installment sale rules,

iv. Applications based on an agreement for the payment of tax with conforming security,

v. Applications for blanket withholding certificates, and

vi. Applications on any other basis.

Withholding certificates based on items (i) – (iii) file a completed Form 8288-B (Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests) with the IRS. If an application for a withholding certificate is submitted to the IRS before or on the date of a transfer and the application is still pending with the IRS on the date of transfer, the correct withholding tax must be withheld, but does not have to be reported and paid over immediately. The amount withheld (or lesser amount as determined by the IRS) must be reported and paid over within 20 days following the day on which a copy of the withholding certificate or notice of denial is mailed by the IRS. The buyer completes Form 8288-A (Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests) and sends in the completed form with the required withholding in the event the certificate is not timely received.

B. Structuring Foreign Investments in the United States.

1. <u>Net Election for U.S. Real Estate Income</u>. In general, foreign persons are subject to tax on the portions of their income which are effectively connected with a U.S. trade or business. In contrast, income other than capital gains is generally subject to a flat 30% tax rate collected via a withholding mechanism. In the real estate context, a foreign person's holding of investment property in the United States often does not arise to the level of a "trade or business." In that case, a foreign person's rental income is subject to this 30% tax. Such treatment can be quite disadvantageous where the gross rental income would otherwise be offset by deductions. However, a foreign person may make an election to treat income from real property located in the United States as effectively connected with a U.S. trade or business. Sections 871(d), 882(d). For foreign individuals, this election is only available with respect to property held for the production of income. If the taxpayer makes this election, deductions associated with the real estate are available to offset income from the real estate.

1. <u>Portfolio Interest Exemption</u>.

a. <u>Background</u>. Non-U.S. investors often look to benefit from the strength and stability of the U.S. economy and the real estate market. However, some of these investors are hesitant to acquire a U.S. real property interest. First, some non-U.S. investors do not want to pay U.S. taxes on their U.S.-source income, whether such income arises from the rental or disposition of a U.S. real property interest. Other investors may not want to acquire a U.S. real property interest because they do not want to file anything with the IRS. Even with the benefit of foreign tax credits and reduced tax rates available pursuant to an applicable income tax treaty, some non-U.S. investors nevertheless find it undesirable to apply for a U.S. tax identification number and/or file a non-resident income tax return or information return.

b. <u>Lending to a U.S. Borrower</u>. Under the right circumstances, lending to a U.S. borrower may address almost all of the non-U.S. investor's concerns. U.S.-sourced interest income received by a non-U.S. lender is generally subject to a 30% tax. However, an exception to this general rule provides that U.S.-sourced interest income which qualifies under the "portfolio interest exemption" is not subject to this tax. Additionally, the non-U.S. lender does not have to file any U.S. tax returns in connection with such income. The loan may be secured by a U.S. real property interest, allowing the non-U.S. lender to at least indirectly participate in the U.S. real estate market. In order to qualify for the portfolio interest exemption, the following requirements must be met.

i. Restrictions on Transferability. The debt instrument must be in registered form. Generally, this means that the debt may only be transferred (i) by the non-U.S. lender surrendering the debt instrument to the U.S. borrower, and having the borrower issue the surrendered debt instrument (or a new one) to the transferee, or (ii) through a book-entry system maintained by the borrower. If the loan is transferable in any other way (e.g., directly from one non-U.S. lender to another), then the interest payable pursuant to the loan will not qualify as portfolio interest.

ii. No Contingent Interest. If the loan provides that any interest payable to the non-U.S. lender is determined by reference to, for example, cash flow, income, fluctuations in property value, or anything similar, then any such interest payable pursuant to the loan will not qualify as portfolio interest.

iii. Rules Regarding the Non-U.S. Lender. Non-U.S. lenders who are related to the U.S. borrower cannot benefit from the portfolio interest exemption. In general, interest payments made to a non-U.S. lender who owns, directly or indirectly, 10% or more of the borrower do not qualify as portfolio interest. The 10% ownership test varies depending on whether the lender is a partnership, in which case the test is applied at the partner (rather than the partnership) level. Complex attribution rules apply to determine whether a non-U.S. lender's relationship with the U.S. borrower violates this rule. The non-U.S. lender cannot be a bank or a controlled foreign corporation (generally defined as any foreign corporation in which U.S. shareholders own more than 50% of the foreign corporation, and each for whom own 10% or more of the foreign corporation). The non-U.S. lender cannot be engaged in the conduct of a U.S. trade or business relating to the loan. Finally, the non-U.S. lender must provide the U.S. borrower a Form W-8 certifying, under penalty of perjury, that among others the non-U.S. lender is not a U.S. person.

IX. STATE TAXES EFFECTING REAL ESTATE.

In addition to the Franchise Tax discussed above, there are additional state taxes applicable to real estate activities that should be considered.

A. Sales Tax on Renovations & New Construction. The distinction between renovations and new construction has been the subject of several Texas Comptroller administrative decisions because new construction is not subject to sales tax while renovating or remodeling real estate is subject to sales tax. In addition, there is not a black and white distinction between taxable real estate remodeling and non-taxable real estate maintenance. Problems arise when non-taxable services or items are sold in conjunction with taxable services or items and no there is no accounting or allocation made between the taxable and non-taxable items. For example, in Comptroller Hearing No. 29,462 (1996) a taxpayer had to submit affidavits, bid sheets, and a building plan to support a claim that a portion of the total charge on a construction contract was non-taxable new construction. Rule 3.357 of 34 Texas Administrative Code provides guidance on this distinction, stating that repairs or restoration performed under a maintenance contract will not change a non-taxable maintenance contract into a taxable restoration contract as long as the charges attributable to repairs and restoration are five percent or less of the overall charge. Cases such as Comptroller Hearing No. 28,746 (1993), in which it was determined that periodically repainting hotel rooms was maintenance as opposed to remodeling, amplify the difficulties in classifying activities that can be argued as either maintenance or remodeling.

B. Sales Tax on Sales in the Entirety. Texas, like other States, imposes a sales tax on the sale of tangible personal property and certain services. While the sale of raw land is not subject to Texas sales tax, the sale of real estate often includes the sale of tangible personal property which may be subject to sales tax, such as a sale of (i) an apartment project with furnished units, (ii) a hotel, (iii) a motel, (iv) an assisted living facility, or (v) a medical office building with specially built facilities for radiology equipment. Note that careful allocation of values in the sales contract may help save tax dollars. To avoid sales tax, taxpayers may seek a lower valuation of the personal property acquired in connection with a real estate purchase. This is obviously at odds with the depreciation planning discussed above, pursuant to which the purchasing taxpayer is usually attempting to allocate a higher valuation in order to establish a high basis for the personal property, which can be depreciated faster than land improvements or buildings.

1. Occasional Sales. Certain "occasional sales" of personal property are exempt from Texas sales tax, including the sale of "the entire operating assets of a business or of a separate division, branch, or indefinable segment of a business." Texas Tax Section 151.304(b)(2). "All operating assets" generally all tangible personal property used exclusively by an entity in providing products or services but does not include the tangible personal property maintained or used for general business purposes. Despite the reference to tangible personal property, intangibles and inventory are excluded from the definition of operating assets. Failure to comply with statutory and regulatory requirements for an "occasional sale" exemption can have significant consequences. Numerous administrative decisions from the Texas Comptroller's office establish that taxpayers who sell less than all of their personalty used in the operation of a business (save a de minimus amount) may cause all of the personalty sold to be subject to Texas sales tax. It is not clear what amount of assets would be considered de minimus.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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State Bar of Texas Tax Section
Tax Law in a Day
February 6, 2015
Dallas, Texas

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

"Recent developments are just like ancient history, except they happened less long ago."

By

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February 6, 2015

Note: This outline was prepared jointly with Martin J. McMahon, Jr., James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida College of Law, Gainesville, FL, and Ira B. Shepard, Professor Emeritus of Law, University of Houston Law Center, Houston, TX. Daniel L. Simmons, Professor Emeritus of Law, University of California Davis, Davis, CA, also contributed to this outline.

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 an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. 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 Bruce's contribution is (relative) youth.

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

I. ACCOUNTING

A. Accounting Methods

1. The Tax Court sides with the taxpayer on application of the completed contact method of accounting to development of planned residential communities. Shea Homes Inc. v. Commissioner, 142 T.C. No. 3 (2/12/14). The taxpayer was a home builder using the completed contract method allowed by § 460(e) (which provides an exception to the percentage-of-completion method otherwise required); the taxpayer developed large, planned residential communities. The question was whether the subject matter of the contracts consisted only of the houses and the lots on which the houses are built, as argued by the IRS, or the home as well as the larger development, including amenities and other common improvements, as argued by the taxpayer. The contracts were home construction contracts under § 460(e)(6) because Reg. § 1.460-3(b)(2)(iii) provides the cost of the dwelling units includes "their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units." More specifically, the taxpayer's position was that the contracts were completed when they meet the test under Reg. § 1.460-1(c)(3)(i)(A) that the property was used by the customer for its intended purpose and 95 percent of the costs of the development had been incurred. Under this argument, final completion and acceptance pursuant to Reg. § 1.460-1(c)(3)(B) did not occur (excluding secondary items, if any, pursuant to Reg. § 1.460-1(c)(3)(B)(ii)) until the last road was paved and the final bond was released. The Tax Court (Judge Wherry), upheld the taxpayer's position. He rejected the IRS's argument that the common improvements were "secondary items." A key element in the holding was that the taxpayer was required by the contracts and by state law to complete common improvements, and that obligation was secured by "hefty performance bonds."

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

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

a. Howard Hughes may have died nearly 40 years ago, but his successors are still trying to fly the Spruce Goose. The Howard Hughes Co., LLC v. Commissioner, 142 T.C. No. 20 (6/2/14). The taxpayer was in the residential land development business. The taxpayer generally sold land through bulk sales, pad sales, finished lot sales, and custom lot sales. In bulk sales, it developed raw land into villages and sold an entire village to a builder. In pad sales, it developed villages into parcels and sold the parcels to builders. In finished lot sales, it developed parcels into lots and sold whole parcels of finished lots to builders. In custom lot sales, it sold individual lots to individual purchasers or custom home builders, who then constructed homes. The taxpayer never constructed any residential dwelling units on the land it sold. The taxpayer reported income from purchase and sale agreements under the § 460 completed contract method of accounting—generally when it had incurred 95 percent of the estimated costs allocable to each sales agreement. The IRS took the position that the land sales contracts were not home construction contracts within the meaning of § 460(e) and that the bulk sale and custom lot contracts were not long-term construction contracts eligible for the percentage of completion method of accounting under § 460. (The IRS conceded that the other contracts were long-term construction contracts.) The Tax Court (Judge Wherry) held that the bulk sale and custom lot contracts were long-term construction contracts under § 460(f)(1), and the taxpayer could report gain or loss from those contracts on the appropriate long-term method of accounting to the extent it had not completed the contracts within a year of entering into them. The contracts included more than just the sale of lots. The costs incurred for a custom lot contract are not really different from the costs for the finished lot sales. The contracts included development of things such as water service, traffic signals, landscaping, and construction of parks, which did not necessarily occur prior to the closing. Completion of the contract thus occurred upon final completion and acceptance of the improvements the cost of which was allocable to the custom lot contracts. However, none of the contracts qualified as home construction contracts eligible for the completed contract reporting method under § 460(e). In relevant part, § 460(e)(6) defines a home construction contract as follows:

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

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

> Our Opinion today draws a bright line. A taxpayer's contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of such dwelling units. It is not enough for the taxpayer to merely pave the road leading to the home, though that may be necessary to the ultimate sale and use of a home. If we allow taxpayers who have construction costs that merely benefit a home that may or may not be built, to use the completed contract method of accounting, then there is no telling how attenuated the costs may be and how long deferral of income may last.

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

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. The IRS continues successfully to flex the awesome power of § 461(h). Suriel v. Commissioner, 141 T.C. No. 16 (12/4/13). The taxpayer was the sole shareholder of an accrual method S corporation that was a cigarette importer. The corporation settled tobacco related claims with 46 States, the District of Columbia, the Commonwealth of Puerto Rico, and 4 U.S. territories by entering into the Tobacco Master Settlement Agreement (MSA). It agreed to pay $242,314,534 in 12 annual installments from 2005 through 2016. Even though none of the amount was paid, the corporation took the entire amount into account in computing the cost of goods sold. It also deducted $4,661,190 as interest owed on its obligation; none of the interest was paid. The IRS disallowed the $242,314,534 deduction on the grounds that economic performance had not yet occurred. The IRS's position was that because the payments were to a qualified settlement fund (QSF), based on § 468B(a) economic performance therefore did not occur until the payments were made. (Section 468B(a) specifically provides: "For purposes of section 461(h), economic performance shall be deemed to occur as qualified payments are made by the taxpayer to a designated settlement fund." *See also* Reg. § 1.468B-3(c)(1).) The taxpayer argued that the obligation arose from the provision of cigarettes to the taxpayer by the manufacturer and that pursuant to § 461(h)(2)(A)(ii) economic performance therefore occurred as the manufacturer provided the cigarettes to the taxpayer. The Tax Court (Judge Goeke) agreed with the IRS. As far as the interest deduction was concerned, Judge Goeke held that where the interest is owed to a QSF, the more specific timing rule in § 468B(a) took precedence over the more general timing rules in §§ 163(a) and 461(a) and disallowed the deduction.

2. This Eagle's wings got clipped. Giant Eagle, Inc. v. Commissioner, T.C. Memo. 2014-146 (7/23/14). The taxpayer owned and operated supermarkets and gas stations. It offered a customer loyalty program by which customers making qualifying purchases at the supermarket could earn "fuelperks!" that were redeemable for a discount against the purchase price of gas at the gas stations. The taxpayer, which used the accrual method, claimed deductions for certain unredeemed fuelperks! for the years at issue. The Tax Court (Judge Haines) disallowed the deductions because the "all events" test of § 461 had not been satisfied. The redemption of fuelperks! was structured as a discount against the purchase price of gas, and the purchase of gas was necessarily a condition precedent to the redemption of fuelperks! The court declined to analogize the fuelperks! to trading stamps or premium coupons "redeemable in merchandise, cash, or other property" issued by a retailer which under Reg. § 1.451-4(a)(1) can offset income in the year issued, applying Rev. Rul. 78-212, 1978-1 C.B. 139, in which the IRS ruled that a taxpayer using the accrual method of accounting that with the sale of products issued coupons that could be redeemed for a discount on the sale prices of products purchased in the future could not apply Reg. § 1.451-4(a)(1); those coupons were not "redeemable in merchandise, cash, or other property" because the redemption of the coupons was conditioned on an additional purchase of the retailer's product by the consumer.

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

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

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. The IRS says that for some purposes pledging ownership of a disregarded LLC is the same thing as mortgaging the LLC's real property. Rev. Proc. 2014-20, 2014-9 I.R.B. 614 (2/24/14). This revenue procedure provides a safe harbor under which the IRS will treat indebtedness that is secured by 100 percent of the ownership interest in a disregarded entity holding real property as indebtedness that is secured by real property for purposes of § 108(c)(3)(A). Section 108(a)(1)(D) allows noncorporate taxpayers to elect to exclude income arising from cancellation of "qualified real property business indebtedness." Section 108(c)(3)(A) defines qualified real property business indebtedness as indebtedness incurred in connection with, and secured by, real property used in a trade or business. The exclusion is limited to the amount by which qualified real property business indebtedness exceeds the fair market value of property secured by the debt, which limits the exclusion under § 108(a)(1)(D) to so-called "phantom gain." Section 108(c)(2)(B) further limits the amount of the exclusion to the aggregate adjusted basis of depreciable real property held by the taxpayer immediately before the cancellation. "Qualified real property business indebtedness" includes only (1) debt incurred or assumed by the taxpayer before 1993 "in connection with" real property used by the taxpayer in a trade or business and secured by the real property and (2) debt incurred or assumed after 1992 to acquire, construct, reconstruct, or substantially improve the property secured by the debt or to refinance qualifying pre-1993 indebtedness to the extent the refinancing does not exceed the original debt. This revenue procedure provides that as long as the indebtedness meets the other requirements of § 108(c)(3), the IRS will treat as indebtedness secured by real property for purposes of § 108(c)(3)(A), and thus as "qualified real property business indebtedness," eligible for exclusion from gross income pursuant to § 108(a)(1)(D), subject to the limitations provided in § 108(c), any indebtedness that meets the following conditions: (1) The taxpayer or a wholly owned disregarded entity of the taxpayer incurs indebtedness. (2) The taxpayer borrower directly or indirectly owns 100 percent of the ownership interest in a disregarded entity owning real property. (3) The taxpayer borrower pledges to the lender a first priority security interest in the borrower's ownership interest in the disregarded entity; any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest. (4) At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by the disregarded entity must be real property used in a trade or business and any other assets held by the disregarded entity must be incidental to the entity's acquisition, ownership, and operation of the real property. (5) Upon default and foreclosure on the indebtedness, the lender will replace the borrower as the sole member of the disregarded entity owning the property.

B. Deductible Expenses versus Capitalization

1. Those fancy Pyrex® and Oneida® branded kitchen products are made by Robinson Knife Manufacturing, which is required to capitalize license fees. Robinson Knife Manufacturing Co. v. Commissioner, T.C. Memo. 2009-9 (1/14/09). The taxpayer designs and produces kitchen tools for sale to large retail chains. To enhance its marketing, the taxpayer paid license fees to Corning for use of the Pyrex trademark and Oneida for use of the Oneida trademark on kitchen tools designed and produced by the taxpayer. The taxpayer's production of kitchen tools bearing the licensed trademarks was subject to review and quality control by Corning or Oneida. The IRS asserted that the taxpayer's licensing fees were subject to capitalization into inventory under § 263A under Reg. § 1.263A-1(e)(3)(ii)(*u*), which expressly includes licensing and franchise fees as indirect costs that must be allocated to produced property. Agreeing with the IRS, the court (Judge Marvel) rejected the taxpayer's argument that the licensing fees, incurred to enhance the marketability of its produced products, were deductible as marketing, selling, or advertising costs excluded from the capitalization requirements by Reg. § 1.263A-1(e)(3)(iii)(A). The court noted that the design approval and quality control elements of the licensing agreements benefited the taxpayer in the development and production of kitchen tools marketed with the licensed trademarks. The court rejected the taxpayer's argument that Rev. Rul. 2000-4, 2000-1 C.B. 331, which allowed a current deduction for costs incurred in obtaining ISO 9000 certification as an assurance of quality processes in providing goods and services, was applicable to the quality control element of the license agreements. The court noted that although the trademarks permitted the taxpayer to produce kitchen tools that were more marketable than the taxpayer's other products, the royalties directly benefited and/or were incurred by reason of the taxpayer's production activities. The court also upheld the IRS's application of the simplified production method of Reg. § 1.263A-2(b) to allocate the license fees between cost of goods sold and ending inventory as consistent with the taxpayer's use of the simplified production method for allocating other indirect costs.

a. But the Second Circuit disagrees. Robinson Knife Manufacturing Co. v. Commissioner**,** 600 F.3d 121 (2d Cir. 3/19/10). Like the Tax Court, the Court of Appeals rejected Robinson's arguments that the royalty payments were deductible as marketing, selling, advertising or distribution costs under Reg. § 1.263-1(e)(3)(iii)(A), or that the royalty payments were deductible as not having been incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced under Reg. § 1.263A-1(e)(3)(ii)(U). The Court of Appeals concluded, however, that "royalty payments which are (1) calculated as a percentage of sales revenue from certain inventory, and (2) incurred only upon sale of such inventory, are not required to be capitalized under the § 263A regulations." The court held that the royalties were neither incurred in, nor directly benefited, the performance of production activities under Reg. § 1.263A-

1(e)(3)(i). Unlike license agreements, the court concluded that Robinson could have manufactured the products, and did, without paying the royalty costs. The royalties were not, therefore, incurred by reason of the production process. The court also concluded that since the royalties were incurred for kitchen tools that have been sold, “it is necessarily true that the royalty costs and the income from sale of the inventory items are incurred simultaneously.” The court noted further that had Robinson’s licensing agreements provided for non-sales based royalties, then capitalization would have been required.

b. Proposed regulations make you wonder why the IRS ever litigated *Robinson Knife*. REG-149335-08, Sales-Based Royalties and Vendor Allowances, 75 F.R. 78940 (12/17/10). The IRS has proposed regulations under § 263A that generally provide the taxpayer-favorable result reached by the Second Circuit in *Robinson Knife*. The proposed regulations provide that sales-based royalties must be capitalized, but also provide that sales-based royalties required to be capitalized are allocable only to property that a taxpayer has sold, rather to closing inventory. The preamble asserts that the Second Circuit in *Robinson Knife* misconstrued the nature of costs required to be capitalized and that the costs of securing rights to use intellectual property directly benefits or are incurred by reason of production processes requiring that the costs be capitalized even if payable only on the basis of the number or units sold or as a percentage of revenue. Nonetheless, the proposed regulations are consistent with the holding of *Robinson Knife* where they provide that sales based royalties are related only to units that are sold during the taxable year. Thus, Prop. Reg. § 1.263A-3(d)(3)(i)(C)(3) would provide that sales based costs would not be included in ending inventory under § 471.

- However, in light of the generous treatment of sales-based royalties, the proposed § 263A regulations, along with proposed amendments to Reg. § 1.471-3(e), require that sales-based vendor allowances [which are rebates or discounts from a vendor as a result of selling the vendor’s merchandise] must be taken into account as an adjustment to the cost of merchandise sold, effectively requiring that such allowances be included in gross income immediately, and would not be taken into account in ending inventory.
- The formulas allocating additional indirect costs to ending inventory under the simplified production and resale methods would be modified to remove capitalized sales based royalties and vendor allowances allocable to property that has been sold.

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

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

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

2. 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.

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 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). 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. An announcement amending regulations—really!!?? Announcement 2013-7, 2013-3 I.R.B. 308 (1/14/13). This announcement amends 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 the temporary regulations 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. Announcement 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.

g. Finally, final regulations providing extensive rules regarding capitalization of expenses for the acquisition, production, or improvement of tangible personal property, and bright-line distinction of deductible repairs. T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 F.R. 57686 (9/19/13). The Treasury Department and IRS have promulgated final regulations under § 263(a) addressing capitalization requirements for expenditures to acquire and improve tangible property that were proposed in REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11), and replacing the temporary regulations promulgated in T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11).[1] The temporary regulations originally were to be effective for tax years beginning on or after 1/1/12, with an expiration date of 12/23/14, but T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 77 F.R. 74583 (12/17/12), delayed the effective date to years beginning on or after 1/1/14, with optional retroactive applicability to taxable years beginning on or after 1/1/12. The final regulations generally are effective for taxable years beginning on or after January 1, 2014. The § 263(a) 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 2011 temporary regulations also revised rules under § 168 regarding disposition of and maintenance of general asset accounts for MACRS property. Except for Reg. § 1.168(i)-7, dealing with multiple asset accounts, these provisions of the temporary regulations (Temp. Regs. §§ 1.168(i)-1T, 1.168(i)-8T), have not been finalized and are still in force. In general, the § 263(a) regulations adopt the provisions of the 2011 and 2008 proposed regulations, but with multiple modifications, including not insignificant redesignation of subsections. Reg. § 1.263(a)-2 provides rules for amounts paid for the acquisition or production of tangible property, and Reg. § 1.263(a)-3 provides rules for amounts paid for the improvement of tangible property. However, these new regulations provide many additional rules. The final 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 costs not more than $200 (the temporary regulations had a $100 ceiling). They add a book-conformity de minimis rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The 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 final regulations do not provide for or authorize a detailed repair allowance rule, and unlike the temporary regulations do not provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

- *Acquisition and Production Costs*. Reg. § 1.263(a)-2 provides that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under Reg. § 1.263(a)-3(e)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to create intangible interests in land are treated as capital expenditures. Reg. § 1.263(a)-1(d)(5). Amounts paid for work performed on a unit of property prior to the date the property is placed in service must also be capitalized. Reg. § 1.263(a)-2(d)(1). Transaction costs to facilitate the acquisition of property are expressly required to be capitalized, Reg. § 1.263(a)-2(f), but facilitative expenditures do not include employee compensation or overhead unless the taxpayer elects to capitalize such expenditures or if capitalization is required under § 263A. Expenditures to defend or protect title must be capitalized. Reg. § 1.263(a)-2(e).
- *Selling Expenses.* Reg. § 1.263(a)-1(e) provides for the capitalization of selling expenses as an offset against sales proceeds (except in the case of dealers).
- *Materials and Supplies.* As under the prior rules, Reg. § 1.162-3 allows a deduction for incidental material and supplies in the year an expenditure is made. Materials and supplies are incidental when they are carried on hand and for which no record of consumption is maintained or when not carried in inventory. A deduction for non-incidental materials and supplies is allowed *in the year the property is consumed.* Materials and supplies include tangible property that is (1) a component acquired to repair or improve a unit of tangible

[1] 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 (3/7/08)), 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)).

property that is not acquired as part of a unit of property, (2) fuel, lubricants, water and similar items that are reasonably expected to be consumed within 12 months, (3) tangible property that is a unit of property with (a) an economic useful life to the taxpayer of not more than 12-months, or (b) that costs not more than $200 (an embedded de minimis rule), and (4) certain rotable spare parts. Reg. § 1.162-3(c). Unlike the temporary regulations, which allowed taxpayers to elect to capitalize the cost of each item of material or supply, the final regulations allow an election to capitalize only rotable, standby, or temporary spare parts (as defined). Items used in the production of other property remain subject to the uniform capitalization rules of § 263A. Reg. § 1.263A-1(b). On sale or disposition, materials and supplies are not treated as capital assets. Reg. § 1.162-3(g).

- *Rotable Spare Parts.* Rotable spare parts are components treated as materials and supplies that are installed in a unit of property, are removable from the unit of property, and are generally repaired and improved for installation in a unit of property or stored for later use. The cost of rotable spare parts is deductible in the year of the disposition of the part. Reg. § 1.162-3(a)(3). Reg. § 1.162-3(e) provides an elective optional method of accounting for the treatment of rotable and temporary spare parts under which (1) the taxpayer deducts the amount paid for the part in the year the part is first installed on a unit of property, (2) in each year the part is removed from a unit of property the taxpayer includes the fair market value of the part in gross income, (3) includes in the basis of the part the value taken into income plus amounts paid to remove the part, (4) includes in the basis of the part any amounts expended to maintain the part, (5) then deducts the basis and any cost incurred to reinstall the part in a unit of property, and finally (6) deducts the basis of the part on final disposition.

- *Financial Accounting De Minimis Rules.* Reg. § 1.263(a)-1(f)(1) allows a taxpayer to elect to deduct expenditures to acquire or produce property (other than land or property produced for resale) if the taxpayer expenses the cost on a certified audited financial statement (including audited financial statements prepared by an independent CPA and used for non-tax purposes and certain financial statements filed with regulatory agencies) pursuant to a written accounting procedure adopted by the taxpayer that treats as expenses amounts paid for (1) property costing less than a specified dollar amount, or (2) property that has an economic useful life of 12 months or less, as long as the amount per invoice (or item) does not exceed $5,000.[2] Notwithstanding these de minimis rules, any amounts paid for property that is, or is intended to be, incorporated into inventory, or that will be used to manufacture inventory, must be capitalized pursuant to § 263A. Property subject to the de minimis rules cannot be treated on sale or other disposition as a capital or § 1231 asset. A taxpayer who elects to apply the de minimis rule of Reg. § 1.263(a)-1(f) must apply the same de minimis rule to materials and supplies, including rotable spare parts, which are then not treated as materials or supplies under Reg. § 1.162-3.

- *Unit of Property.* Reg. § 1.263(a)-3(e). The unit of property concept is central to the proposed regulations' requirement that improvements to a unit of property must be capitalized.

- Reg. § 1.263(a)-3(e)(2) provides that a building and its structural components (as defined in Reg. § 1.48-1(e)(2)) are treated as a unit of property.[3]

[2] The $5,000 limit replaces the limit in the 2011 temporary regulations, which was an aggregate amount that did not exceed the lesser of 0.1 percent of the taxpayer's gross receipts or 2 percent of the taxpayer's total depreciation and amortization expense reflected in its financial statement; the 2011 temporary regulations removed a provision in the 2008 proposed regulations requiring that the aggregate amount deducted not materially distort the taxpayer's income for purposes of § 446.

[3] Under Reg. § 1.48-1(e)(2), structural components of a building include such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and

However, the improvement rules must be separately applied to components of a building including heating, ventilation and air conditioning systems, plumbing systems, electrical systems, elevators and escalators, fire protection and security systems, gas distributions systems, and other systems identified in published guidance. Condominium units and cooperative units are each treated for the owner as a unit of property. Similarly, a leasehold interest in a portion of a building is treated as a unit of property.

- Reg. § 1.263(a)-3(e)(1) defines a unit of property for property other than buildings as including all the components that are functionally interdependent. Components of property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. However, a component that is recorded on the taxpayer's books as having a different economic useful life or which is in a different class of property for MACRS depreciation would be treated as a separate unit of property. Thus, for example, all of the component parts of a railroad locomotive constitute a single unit of property, as does a truck trailer and its tires (unless the taxpayer's financial statements treat them as separate property). A special rule applies to "plant property," which is a functionally integrated collection of equipment and machinery used to perform an industrial process; each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment constitutes a separate unit of property. Determinations of a unit of property with respect to network assets are based on the taxpayer's facts and circumstances unless otherwise provided in published guidance. Network assets include property such as railroad tracks, oil, gas, water and sewage pipelines, power transmission lines, and cable and telephone lines that are owned or leased by taxpayers in those industries.

- *Capitalization of Improvements.* Expenditures to improve a unit of property must be capitalized. Reg. § 1.263(a)-3(d). Amounts expended for repairs and maintenance of tangible property are deductible if they are not required to be capitalized under Reg. § 1.263(a)-3. Reg. § 1.162-4. Expenditures that improve tangible property and that are required to be capitalized include expenditures that:

  - ºResult in a "betterment" to a unit of property;
  - ºRestore a unit of property; or
  - ºAdapt the unit of property to a new or different use.

Reg. § 1.263(a)-3(f) provides special rules requiring a lessee to capitalize expenditures for improvements to a unit of leased property. A lessor is required to capitalize the cost of improvements to leased property paid directly or through a construction allowance to the lessee. (The preamble to the 2011 temporary regulations states that the recovery period for an improvement or addition to the "underlying property" begins on the placed-in-service date of the improvement or addition. See I.R.C. § 168(i)(6); Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E).)

- *Betterment.* Reg. § 1.263(a)-3(j). An expenditure must be capitalized if it results in the "betterment" of a unit of property. An expenditure meets this standard only if it — (1) "[a]meliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property ... ," (2) "[r]esults in a material addition ... to the unit of property," or (3) "[i]s reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the unit of property."[4] Determination of whether an expenditure results in a betterment is factual and requires a comparison of the condition of the property immediately prior to the circumstance necessitating the expenditure (or the condition of property the last time the taxpayer corrected for normal wear and tear) with the condition of the property after the expenditure. An expenditure that results in a

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elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

[4] Former Temp. Reg. § 1.263(a)-3(h)(iii) applied a different standard for the third criterion, finding a betterment if the expenditure "[r]esults in a material increase in capacity ..., productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property."

betterment of a component of a building is treated as a betterment to the unit of property consisting of the building and its structural components. If an expenditure is made to counter the effects of normal wear and tear, the betterment determination is made by comparing the condition of the property immediately after the expenditure with its condition after the last time the taxpayer corrected the effects of normal wear and tear, or with its condition when placed in service by the taxpayer (if the taxpayer has not previously corrected the effects of wear and tear). Reg. § 1.263(a)-3(j)(3)(iii)(B). If an expenditure is made in response to a particular event that damaged the property, the betterment determination is made by comparing the condition of the property immediately after the expenditure with its condition immediately before the particular event. Reg. § 1.263(a)-3(j)(3)(iii)(C). Although the 2011 temporary regulations provided that the betterment determination was to be made on the basis of "all the facts and circumstances, including, but not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure on its applicable financial statement," former Temp. Reg. § 1.263(a)-3T(h)(3)(i), this provision was eliminated in the final regulations; nevertheless the preamble states that the "IRS and the Treasury Department believe that an analysis of a taxpayer's particular facts and circumstances is implicit in the application of all the final regulations governing improvements and need not be specifically provided in the application of the betterment rules."

- *Restoration.* Reg. § 1.263(a)-3(k). An expenditure must be capitalized as a restoration if it (1) replaces a component for which the taxpayer has deducted a loss, (2) replaces a component the adjusted basis of which has been accounted for in realizing gain or loss on a sale or exchange of the component, (3) repairs damage for which the taxpayer has deducted a casualty loss under § 165, (4) returns the property to its ordinary operating condition after the property has fallen into a state of disrepair and is no longer functional, (5) results in rebuilding the property to a like-new condition at the end of its class life under the § 168(g) alternative depreciation system, or (6) is for the replacement of a major component or structural part of the unit of property. Expenditures to repair damage to a unit of property for which the taxpayer has claimed a casualty loss for the damage must be capitalized only to the extent that (1) the basis of the property for which a loss deduction was allowed exceeds (2) the amounts paid that represent an improvement to the property measured by its condition prior to the casualty. Reg. § 1.263(a)-3(k)(4). In other words, repair costs in excess of the casualty loss deduction that merely restore the property to its pre-casualty condition are deductible, but repair costs equal to the casualty loss must be capitalized.[5] See Reg. § 1.263(a)-3(k)(7), Exs. 3-5. Whether there has been a replacement of a major component or structural part is determined under the facts and circumstances and includes replacement of a major component or structural part that comprises a large portion of the physical structure of the unit of property or that performs a discrete and critical function in the operation of the unit of property. Again, the restoration of a component of a building is treated as a restoration of the unit of property consisting of the building and its structural components.
- *New Use.* Reg. § 1.263(a)-3(*l*). A unit of property is treated as adapted to a new or different use if the adaptation is not consistent with the taxpayer's "ordinary use of the unit of property at the time originally placed in service by the taxpayer." An expenditure to adapt a building system to a new use must be capitalized.
- *Removal Costs.* The 2011 temporary regulations treated component **removal** costs as an indirect cost that had to be capitalized if the **removal** costs directly benefited or were incurred by reason of an improvement. The final regulations have changed this rule. Reg. § 1.263(a)-3(g)(2) provides that if a taxpayer disposes of a depreciable asset (including a partial disposition under Prop. Reg. § 1.168(i)-1(e)(2)(ix) or Prop. Reg. § 1.168(i)-8(d)) and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, the costs of removing the asset or component are not required to be capitalized. If a taxpayer

[5] This differs from the Temporary Regulations under which the full amount of the casualty restoration costs would have been subject to capitalization.

disposes of a component of a unit of property and the disposal is not a disposition for tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property.

- *Rehabilitation doctrine is no more.* Reg. § 1.263(a)-3(g)(1) eliminates the judicially created rehabilitation doctrine by providing that "indirect costs that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement." Although the temporary regulations specifically provided that if otherwise deductible repairs benefit or are incurred by reason of an improvement, the cost of the repairs had to be capitalized under § 263A, the final regulations omit this sentence. However, some added examples illustrate when § 263A requires capitalization.

- *Routine Maintenance Safe Harbor.* Reg. § 1.263(a)-3(*i*)(1) provides safe harbor rules for routine maintenance of a unit of property that is not treated as improving the property. For property other than a building or a structural component of a building, routine maintenance is defined as "the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition." Reg. § 1.263(a)-3(*i*)(1)(ii). Examples include inspection, cleaning, and testing of the unit, and replacement of parts of the unit. The safe harbor applies to activities that the taxpayer reasonably expects to perform more than once during the class life of the property, as determined under the MACRS alternative depreciation schedule of § 168(g). Routine maintenance includes maintenance with respect to and the use of rotable spare parts. Routine maintenance excludes activities that follow a basis recovery event similar to the items that are described as restorations.

- *Routine Maintenance Safe Harbor for Buildings*. The 2011 temporary regulations did not provide a routine maintenance safe harbor for buildings, but the 2013 final regulations provide two safe harbors for buildings. For buildings and structural components of building, routine maintenance is defined as "the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of any of the properties ... to keep the building structure or each building system in its ordinarily efficient operating condition." Reg. § 1.263(a)-3(*i*)(1)(ii). Examples include the inspection, cleaning, and testing of the building structure or each building system, and the replacement of damaged or worn parts with comparable and commercially available replacement parts. However, the activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service. Reg. § 1.263(a)-3(*i*)(1)(ii).

- *Routine Maintenance Safe Harbor for Buildings of "qualifying small taxpayers."* The 2013 final regulations also provide an additional safe harbor election for building property held by taxpayers with gross receipts of $10,000,000 or less ("a qualifying small taxpayer"). Reg. § 1.263(a)-3(h). A qualifying small taxpayer may elect to not apply the improvement rules to an eligible building if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities with respect to the building does not exceed the lesser of $10,000 or two percent of the unadjusted basis of the building. Eligible building property includes a building that is owned or leased by the qualifying taxpayer, provided the unadjusted basis of the property is $1,000,000 or less.

- *Repairs.* Reg. § 1.162-4 allows as a deductible repair expense any costs that are not required to be capitalized under Reg. § 1.263(a)-3. The final regulations do not provide for a repair allowance. Temp. Reg. § 1.263(a)-3T(*l*) provided that taxpayers would be permitted to use a repair allowance method authorized by published guidance in the Federal Register or the Internal Revenue Bulletin. This provision was deleted in finalizing the regulations.

- *Examples.* The regulations are full of examples that seem to cover most of the litigated cases and rulings addressing capitalization versus repair. The examples are necessary to understand the substantive provisions, which, although intended to provide clarity, are not so clearly applied.

• *Effective Dates.* In general, the final regulations apply to taxable years beginning on or after 1/1/14. However, certain rules apply only to amounts paid or incurred in taxable years beginning on or after 1/1/14. The various effective dates are in Regs. §§ 1.162-3(j), 1.162-4(c), 1.162-11(b)(2), 1.165-2(d), 1.167(a)-4(b), 1.167(a)-7(f), 1.167(a)-8(h), 1.168(i)-7(e), 1.263(a)-1(h), 1.263(a)-2(j), 1.263(a)-3(r), 1.263(a)-6(c), 1.263A-1(l), and 1.1016-3(j).

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

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

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

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

5. In the Sixth Circuit, even if not necessarily in the rest of the country, lease termination expenses are deductible and not capitalized into the basis of an acquired building. ABC Beverage Corp. v. United States, 756 F.3d 438 (6th Cir. 6/13/14), *aff'g* 577 F. Supp. 2d 935 (W.D. Mich. 8/27/08). The taxpayer operated a bottling facility in a leased building. Because it considered the rent to be excessive, it exercised an option to purchase the property. Appraisals valued the property without the lease at $2.75 million, but the taxpayer determined that the fair market value of the property with the lease would be at least $9 million and it eventually bought the property for more than $9 million. The taxpayer treated $2.75 million as its cost of acquiring the property and deducted $6.25 million as a business expense for terminating the lease. Applying *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948), the Sixth Circuit, in an opinion by Judge Cole, upheld the deduction, rejecting the government's argument that the Supreme Court's subsequent decisions in *Woodward v. Commissioner*, 397 U.S. 572 (1970), *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), and *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992) had overruled *Cleveland Allerton Hotel, Inc*. Further, the court held that § 167(c)(2), which was enacted after *Cleveland Allerton Hotel, Inc*. was decided, did not apply. Section 167(c)(2) provides that "[i]f any property is acquired subject to a lease," the taxpayer is prohibited from allocating any part of the property's cost to the leasehold interest and is required to capitalize the entire cost of the property. The court concluded that "the phrase 'acquired subject to a lease' is best understood to encompass only those acquisitions in which the lease continues after the purchase." In so doing, the Sixth Circuit acknowledged that in *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (1993), the Tax Court had reached the opposite conclusion regarding the ambit of § 167(c)(2), but disagreed with the Tax Court's conclusion.

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

- Reg. § 1.174-2(a)(1) provides that the ultimate success, failure, sale or use of a product is not relevant to a determination of eligibility of expenditures as research or experimental expenditures under § 174.
- Reg. § 1.174-2(b)(4), as interpreted by the preamble to the proposed and final regulations, makes clear that, as an application of the general definition of research expenditures, the depreciable property rule should not be applied to exclude otherwise eligible expenditures.
- Under Reg. § 1.174-(a)(2), research expenditures to develop a product include development of a pilot model. Reg. § 1.174-2(a)(4) defines a pilot model as "any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product."
- The regulations amend Reg. § 1.174-2(a)(1) to "clarify" that production costs after uncertainty is eliminated are not eligible under § 174 by providing that "Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated."
- Reg. § 1.174-2(a)(5) adopts a "shrinking back rule" that provides that research and experimental expenditures for the improvement of a component of a larger design may be eligible under § 174, but uncertainty with respect to components does not necessarily indicate uncertainty with respect to the product as a whole.
- The amendments to Reg. § 1.174-2 apply to tax years ending on or after 7/21/14, but taxpayers can apply these amendments to tax years for which the period of limitations on assessment of tax has not expired.

C. Reasonable Compensation

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

D. Miscellaneous Deductions

1. A partner's unreimbursed reimbursable expenses incurred on behalf of the partnership are not deductible on his own return. McLauchlan v. Commissioner, T.C. Memo. 2011-289 (12/19/11). The taxpayer was a partner in a law firm and he paid various expenses, such as advertising, home office, automobile, travel, meals, entertainment, cell phone, professional organizations, continuing legal education, state bar membership, supplies, interest, banking fees and legal support services in connection with his law practice. The partnership reimbursed him for over $60,000 of the expenses in each year in question, but he claimed more than $100,000 of additional expense on Schedule C in each year. The Tax Court (Judge Kroupa) articulated the principal issue as whether a partner can deduct unreimbursed expenses incurred in furtherance of the partnership's business. She then articulated the relevant legal principle as prohibiting a partner from deducting on his own return expenses of the partnership, even if the expenses were incurred by the partner in furtherance of partnership business, unless there is an agreement among partners, or a routine practice equal to an agreement, that requires a partner to use his or her own funds to pay a partnership expense, citing *Cropland Chem. Corp. v. Commissioner*, 75 T.C. 288, 295 (1980), *aff'd without published opinion*, 665 F.2d 1050 (7th Cir. 1981). In the instant case, the partnership agreement required petitioner to pay "indirect partnership expenses" that were unreimbursable, but there was no routine practice that required petitioner to pay any other partnership expenses. Thus, expenses at issue were deductible only if they were unreimbursable indirect partnership expenses that were actually incurred. Turning to the facts, Judge Kroupa found that all of the claimed expenses were either reimbursable under the partnership agreement or not properly substantiated. Accordingly, all of the claimed deductions were disallowed and § 6662 accuracy related penalties were upheld.

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

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

In light of this law, the Court of Appeals found that the Tax Court record did not establish that the partnership had a routine practice requiring partners to pay any of its expenses outside the terms of the partnership agreement. Accordingly, "expenses McLauchlan claimed as deductions beyond those identified in the partnership agreement, such as for advertising, contract labor, home insurance, interest, office supplies, utilities, and wages, were expenses McLauchlan chose to incur, rather than ones called for by AR's partnership agreement. They therefore were not deductible on McLauchlan's individual tax return." Presumably, the court found these expenses not to have been "necessary" in the strictest sense of the word. Next the Court of Appeals concluded that the expenses McLauchlan was required by the partnership agreement to incur, except automobile expenses, were reimbursable by the partnership, but McLauchlan failed to seek reimbursement. The court cited *Occhipinti v. Commissioner*, T.C. Memo. 1969-190, *aff'd* *sub nom. Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971), for the proposition that if a partner has a right to reimbursement and does not pursue it, the partner is not entitled to deduct the expenses. Thus, he was "not required to pay, without reimbursement, any of the claimed expenses at issue and thus they were not properly deductible as unreimbursed partnership expenses."

2. Cash value life-insurance through off-shore insurance companies and LLCs don't produce deductible premiums. Salty Brine 1, Ltd. v. United States, 111 A.F.T.R.2d 2013-2308 (N.D. Tex. 5/16/13). In a marketed insurance tax shelter arrangement that even Jenkens & Gilchrist would not bless with an opinion, the court denied § 162 deductions for premiums paid for business protection insurance issued by off-shore affiliates of Fidelity and Citadel Insurance companies. The policies included cash value life insurance and related annuities that the court found did not protect the business from risk and merely represented an attempt to funnel cash from the businesses to families of the owners. Section 6662 penalties were upheld.

a. Affirmed by the Fifth Circuit. Salty Brine 1, Ltd. v. United States, 761 F.3d 484 (5th Cir. 7/31/14). The Fifth Circuit (Judge Davis) affirmed the district court, finding that the arrangement was an invalid attempt to assign income, so the alleged insurance premiums were not deductible. He also found that the arrangement lacked economic substance, based on its failing the first of the three factors of the "multi-factor test for when a transaction must be honored as legitimate for tax purposes." This test requires that the transaction satisfy all three of the following factors, i.e. if it:

> (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features.

3. A judge lets the jury decide how much of $126,796,262 of a $385,147,334 settlement payment under the False Claims Act is compensatory and how much is a nondeductible penalty. Fresenius Medical Care Holdings, Inc. v. United States, 111 A.F.T.R.2d 2013-1938 (D. Mass. 5/9/13). The taxpayer deducted the full amount of a $385,147,334 settlement with the government under the False Claims Act (for Medicare and Medicaid fraud), which provides for a penalty of not less than $5,000 and not more than $10,000 plus three times the amount of damages the government sustains. The settlement agreement was silent regarding the allocation of the payment between compensatory and punitive amounts, although it did allocate $65,800,555 to *qui tam* relators' awards. The agreement expressly disclaimed any resolution of the tax treatment of the payment. The IRS allowed a portion of the deduction but disallowed as a fine or similar penalty, which is nondeductible under § 162(f), $126,796,262 of the claimed deduction. The District Court denied cross motions for summary judgment because "real disputes remained about the purpose of the payments," and on a motion for entry of judgment held that the jury properly determined that $95,000,000 of the disputed amount of the settlement paid to the government was compensatory and therefore deductible. The court explained that "a manifest agreement is not necessary for [the taxpayer] to establish that all or some portion of the payments at issue were made in settlement of non-punitive FCA liability." It concluded that "to determine whether the payments made by [the taxpayer] to the government in excess of the amount already deemed deductible by the IRS were compensatory damages, it was necessary to consider both the language of the settlement agreements and non-contractual evidence regarding the purpose and application of the payments."

a. And the First Circuit says to the government ♪♫"that's ok, that's alright, I'm gonna do something you don't like."♫♪ Fresenius Medical Care Holdings, Inc. v. United States, 114 A.F.T.R.2d 2014-5164 (1st Cir. 8/13/14). In an opinion by Judge Selya, the First Circuit affirmed the District Court's judgment. The Court of Appeals rejected the government's argument that "the absence of an agreement between the parties as to whether the payments will be deductible defeats Fresenius's claim of deductibility," characterizing the government's argument as "assign[ing] talismanic significance to the presence or absence of a tax characterization agreement between the settling parties." Rather, the court held that in determining the tax treatment of a False Claims Act civil settlement, a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the government and the settling party. The court reasoned as follows:

> The government's proposed rule is also in serious tension with yet another fundamental tenet of tax law. This tenet holds that amounts paid or received in settlement should receive the same tax treatment, to the extent practicable, as would have applied had the dispute been litigated and reduced to judgment. ***See, e.g.***, *Lyeth v. Hoey*, 305 U.S. 188, 196; *Freda v. Comm'r*, 656 F.3d 570, 574 (7th Cir. 2011); *Alexander v. IRS*, 72 F.3d 938, 942 (1sst Cir. 1995). The government's position here inters that tenet in the graveyard of forgotten canons.
>
> When an FCA claim is tried rather than settled, there will perforce be no characterization agreement available to guide the tax treatment of awarded damages. Nevertheless, some portion of the award beyond single damages may subsequently be found to have a compensatory purpose. See *Chandler*, 538 U.S. at 130–31; *Bornstein*, 423 U.S. at 315. Hence, that portion of the award will be deductible. See 26 C.F.R. §1.162-21(b). The same result logically should obtain in the settlement context. Thus, a rule that requires a tax characterization agreement as a precondition to deductibility would produce an infelicitous asymmetry.

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

4. The Tax Court shows some more love for captive insurance companies. Rent-A-Center, Inc. v. Commissioner, 142 T.C. No. 1 (1/14/14). The parent of an affiliated group of domestic corporations (RAC) conducted its business through stores owned and operated by its subsidiaries. The parent established a Bermudian insurance company (Legacy) and the operating subsidiaries entered into insurance contracts with Legacy pursuant to which each subsidiary paid Legacy an amount, determined by actuarial calculations and an allocation formula, relating to workers' compensation, automobile, and general liability risks. Legacy, in turn, reimbursed a portion of each subsidiary's claims relating to these risks. Although the parent corporation was a listed policyholder, no premium was attributable to it because it did not own stores, have employees, or operate vehicles. RAC paid the premiums relating to each policy. The operating subsidiaries deducted, as insurance expenses, the payments to Legacy. In addition, in a complex arrangement RAC guaranteed up to $25 million of Legacy's liabilities, and the guaranty was treated as an asset of Legacy by the Bermudian insurance regulators. The IRS issued a deficiency notice based on the position that the payments by the operating subsidiaries to Legacy were not deductible as insurance premiums. The Tax Court (Judge Foley) held that the payments were deductible as insurance premiums. First, in forming Legacy, RAC "made a business decision premised on a myriad of significant and legitimate nontax considerations." Second, the flow of funds was not circular. Third, Legacy was not a "sham," but "was a bona fide insurance company." Legacy "charged actuarially determined premiums; was subject to the BMA's regulatory control; met Bermuda's minimum statutory requirements; paid claims from its separately maintained account; and, as respondent's expert readily admitted, was adequately capitalized." Finally, the payments were insurance premiums, because the policies shifted risk between RAC's operating subsidiaries and Legacy. Under the principles of *Humana Inc. & Subs. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), *aff'g in part, rev'g in part and remanding*, 88 T.C. 197 (1987), because the subsidiaries owned no stock in the captive insurance company, risk was shifted and distributed. The court expressly rejected adoption of the IRS's "economic family theory," ***see*** Rev. Rul. 77-316, 1977-2 C.B. 53, as have other courts that have examined the issue.

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

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

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

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

7. Intention to operate a rental business doesn't establish its operation. Hume v. Commissioner, T.C. Memo. 2014-135 (7/7/14). The taxpayers claimed mortgage interest deductions on Schedule C for a residential property they owned and had acquired with an intention eventually to rent out, but in which they resided in the years in question. The Tax Court (Judge Wherry) upheld the IRS's determination that the taxpayers were not entitled to Schedule C deductions because the property was a personal residence. Although nothing in the record contradicted the taxpayer's testimony that he purchased the property with the purpose of renting it out for profit, and the record arguably reflected "that he may have regularly and actively engaged in efforts to further and promote the activity," his testimony that he never was able to get the property into a "condition to be able to" rent it, and the fact that he was residing in it contradicted any argument that the taxpayers were renting out or able to rent out the property for the years in question. The taxpayers were able to deduct the mortgage interest payments only as qualified residence interest on Schedule A, Itemized Deductions, subject to the $1.1 million § 163(h) limitation. The remaining mortgage interest paid was not deductible.

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

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

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

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

10. Don Draper likely would have tried to take advantage of this rule had it been around when he was renting hotel rooms in NYC. T.D. 9696, Local Lodging Expenses, 79 F.R 59112 (10/1/14). The Treasury Department has promulgated Reg. § 1.162-32 (proposed as Reg. § 1.162-31 in REG-137589-07, Local Lodging Expenses, 77 F.R. 24657 (4/25/12)) with minor clarifications. Reg. § 1.162-32 allows a deduction for local lodging, i.e., lodging while the taxpayer is not away from home, in carrying on a taxpayer's trade or business (whether or not as an employee) under a "facts and circumstances" test. One factor is whether the taxpayer incurs the expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. To the extent an employer reimburses an employee for local lodging expenses, the reimbursement may be excluded from the employee's gross income if the expense allowance arrangement satisfies the requirements of an accountable plan under § 62(c) and the applicable regulations. The regulations provide a safe harbor for local lodging at business meetings and conferences. A taxpayer's local lodging expenses that do not satisfy the safe harbor nevertheless may be deductible depending on the taxpayer's facts and circumstances. The examples indicate that there must be a bona fide business reason for the overnight stay, and, if provided by an employer, there must be a substantial noncompensatory reason. The regulations apply to expenses paid or incurred after 9/30/13, but taxpayers may apply the regulations to expenses paid or incurred in taxable years ending before 10/1/14, for which the period of limitation on credit or refund under § 6511 has not expired.

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

11. Wouldn't it be better to increase teachers' pay? TIPA retroactively extended through 2014 the § 62(a)(2)(D) above-the-line deduction for up to $250 of teachers' classroom supplies expenses.

E. Depreciation & Amortization

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

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

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

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

- *General Asset Accounts.* Consistent with prior Reg. § 1.168(i)-1, the temporary regulations provide for an election to group assets into one or more general asset accounts. Temp. Reg. § 1.168(i)-1T(c)(2) provides for grouping assets in a general asset account as long as the assets have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. The temporary regulations do not include the requirement of prior regulations that general asset accounts include only assets in the same asset class. Assets eligible for additional first year depreciation deductions must be grouped with assets eligible for the same first year depreciation deductions and may not be grouped with assets not eligible for additional first year depreciation. Temp. Reg. § 1.168(i)-1T(c)(2)(ii)(D) and (E). The temporary regulations expand existing rules for dispositions of assets from a general asset account to encompass as a disposition the retirement of a structural component of a building. As under existing rules, the temporary regulations treat the basis of any asset disposed of from a general asset account as zero, and any amount realized results in ordinary gain. The taxpayer continues to depreciate assets in the general asset account as if no disposition occurred. Temp. Reg. § 1.168(i)-1T(e)(2). However, consistent with existing regulations, the temporary regulations allow a taxpayer to elect to terminate general asset account treatment on disposition of an asset in a qualifying disposition, in which case gain or loss is recognized under the rules of Temp. Reg. § 1.168(i)-8T. The list of qualifying dispositions is expanded generally to include any disposition. Temp. Reg. § 1.168(i)-1T(e)(3). In addition, general asset accounts are terminated in certain nonrecognition dispositions and on termination of a partnership under § 708(b)(1)(B). Gain or loss may also be recognized on disposition of all of the assets, or the last asset, in a general asset account. Temp. Reg. § 1.168(i)-1T(e)(3)(ii).

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

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

c. Have your clients been wasting time trying to comply with the Temporary Regulations in 2012? Yes, they have. Further guidance 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).

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

- Temp. Reg. § 1.168(i)-1T(c), dealing with general asset accounts and Temp. Reg. § 1.168(i)-8T(d), dealing with dispositions, both of which were promulgated in T.D. 9564 (12/27/11), and proposed in REG-168745-03 (12/27/11) have not been replaced by final regulations.

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

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

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

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

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

- *Gain or loss.* Gain or loss on the sale, exchange or conversion of an asset is determined under applicable tax principles. Loss on abandonment is determined from the "adjusted depreciable basis" of the asset (basis adjusted for depreciation). Reg. § 1.168(i)-8(e). Recognized loss on other dispositions is the excess of the adjusted depreciable basis of the asset over fair market value. Disposition of an asset in a single asset account terminates depreciation for the asset as of the time of the disposition. If the taxpayer accounts for the asset disposed of in a multiple asset account or pool and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the asset disposed of, the taxpayer may use any reasonable method that is consistently applied to all assets in the same multiple asset account. Reg. § 1.168-8(e). Identification of the asset disposed of from a multiple asset account, and its basis, is generally determined from the taxpayer's records. Reg. § 1.168(i)-8(f) & (g). If the taxpayer's records do not identify assets, a first-in first-out method, a modified FIFO method, a mortality dispersion table method, or any other method designated by the IRS may be used. The asset cannot be larger than a unit of property. In the case of a disposition of a structural component of a building, the structural component is the asset disposed of. An improvement placed in service after the asset is treated as a separate asset. Reg. § 1.168(i)-8(e)(4).

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

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

2. **"[F. Scott] Fitzgerald asserted that 'the very rich *** are different from you and me.'"** Brown v. Commissioner, T.C. Memo. 2013-275 (12/3/13). On December 30, 2003, the taxpayer, an extraordinarily successful insurance salesman, took ownership of a $22 million airplane in Portland, Oregon. He flew from there to Seattle to Chicago for what he claimed were business meetings, and then back to Portland. The taxpayer argued that these flights put the plane in service in 2003, thereby entitling him to 50 percent bonus-depreciation under § 168(k)(4), as enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 201, 117 Stat. at 756, which was available for certain qualified property placed in service before January 1, 2004. However, a few days later he had the airplane flown to a plant in Illinois where it underwent modifications costing more than $500,000 — including the installation of a conference table and equipment for Power Point presentations — that were completed about a month later. The IRS disallowed the claimed depreciation deductions on the ground that as a result of the additional modifications the airplane had not been put into service until 2004. The Tax Court (Judge Holmes) evaluated the evidence introduced to support the taxpayer's claim that the Seattle trip resulted in the airplane being placed in service in 2003, and the evaluation is best summarized by the statement that "we sense something doesn't smell quite right with the whole Seattle visit." Among other things, the flight logs indicated a trip of much shorter duration than claimed in the taxpayer's testimony, and a letter from the client with whom the taxpayer claimed to have met thanking him for the visit appeared to have been prepared by one of the taxpayer's employees and presented to the client for his signature after the audit had commenced. More importantly, turning the question of what "placed in service" means, Judge Holmes concluded that because taxpayer wanted an airplane on which business meetings could be held, and not merely for transportation, the modifications made in 2004 were necessary for full operation of the airplane in the taxpayer's insurance business on a regular basis — the taxpayer testified that the "modifications were 'necessary' and 'required'" — the airplane had not been placed in service until 2004. Thus, it did not qualify for bonus depreciation. Although

Judge Holmes declined to uphold the IRS's assessment of a civil fraud penalty, he did uphold a § 6662 substantial understatement penalty.

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

Passenger Automobiles:	
1st Tax Year	*$3,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*
Trucks and Vans:	
1st Tax Year	*$3,460*
2nd Tax Year	*$5,400*
3rd Tax Year	*$3,350*
Each Succeeding Year	*$1,975*

4. Tangible assets used in converting corn to fuel grade ethanol are in asset class 49.5 and therefore have a recovery period of seven years under the general depreciation system. Rev. Rul. 2014-17, 2014-24 I.R.B. 1093 (5/20/14). This ruling addresses the proper asset class under Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785, for the depreciation of tangible assets that are used in converting corn to fuel grade ethanol. The ruling concludes that, subject to certain exceptions, such assets are in asset class 49.5, Waste Reduction and Resource Recovery Plants. These assets have a class life of ten years under Rev. Proc. 87-56 and therefore, under § 168(c) and (e), have a recovery period of seven years under the general depreciation system. (The ruling rejects placing such assets in asset class 28.0, Manufacture of Chemicals and Allied Products, which would have provided a recovery period of five years under the general depreciation system.) The IRS states in the ruling that it "will not apply the holding in this revenue ruling to tangible assets that are used in converting biomass to a liquid fuel such as fuel grade ethanol that a taxpayer places in service before June 9, 2014."

5. Certain depreciation and amortization provisions of TIPA:

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

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

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

d. Do we see Mitch McConnell's fingerprints here? TIPA retroactively extended through 12/31/14 the classification of certain race horses as 3-year MACRS property. It also extended the election under § 179E to treat 50 percent of the cost of any qualified mine safety equipment as an expense in the tax year in which the equipment is placed in service.

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

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

F. Credits

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

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

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

2. The Tax Court just says "no" to R&D credits claimed with 20/20 hindsight provided by alliantgroup. Shami v. Commissioner, T.C. Memo. 2012-78 (3/21/12). The taxpayer's S corporation hired alliantgroup to conduct § 41 research tax credit studies covering the years in question. The research and development department staff ranged from 18 to 27 and included chemists, technicians, and a vice president of research and development who supervised the department. The alliantgroup concluded that the corporation was entitled to claim the § 41 research credit based in part on wages paid to two individuals who were, respectively, its chairman of the board, chief executive officer, president, and secretary (Shami), and its executive vice president and the sole member of its sales and marketing committee (McCall), neither of whom had formal education or training in any physical or biological science or engineering. The only issue in the case involved credits based on wages paid to the two executives. The taxpayers "failed to provide any documentation that establishe[d] how much time, if any, Mr. Shami or Mr. McCall spent performing research and development services during the relevant years," but argued that the court "must estimate the amount of wages allocable to qualified services if [it found] either Mr. Shami or Mr. McCall performed qualified services." The Tax Court (Judge Kroupa) rejected the taxpayer's argument, on the basis that the *Cohan* rule (*Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930)) applies only if there is a reasonable basis on which the court can make an estimate, and that in this case the taxpayer failed to satisfy the court that there was sufficient evidence to estimate the appropriate allocation of wages between qualified services and nonqualified services. Judge Kroupa found *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009), which did apply the *Cohan* rule in determining the § 41 research credit, to be inapposite, stating that in *McFerrin* "the Court of Appeals for the Fifth Circuit did not overrule, or even address, the basic requirement under *Cohan* that a court must have a reasonable basis upon which to make an estimate."

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

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

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

3. Fifty ways to determine when construction begins. Notice 2013-29, 2013-20 I.R.B. 1085 (4/15/13). The American Taxpayer (and not so grand compromise) Relief Act of 2012 extended the renewable electricity production tax credit of § 45 and the elective § 48 alternative investment tax credit for electricity produced at a qualified facility if construction of the facility is commenced before 1/1/14. Qualified facilities include wind facilities, closed-loop biomass facilities, open-loop biomass facilities, geothermal facilities, landfill gas facilities, trash facilities, hydropower facilities, and marine and hydrokinetic facilities. The notice provides that a taxpayer can demonstrate that construction has commenced by establishing that "physical work of a significant nature" is undertaken, or by meeting a safe harbor that five percent of the cost of a project is incurred before 1/1/14. The IRS may determine that construction has not commenced if the taxpayer does not maintain a continuous program of work. Significant physical work includes excavating foundations and the manufacture of components under a binding written contract that are not components held in inventory by the vendor. Significant physical work includes work on component parts of multiple facilities that will be treated as a single facility that are integral to a project such as roads, but not fences or buildings. Significant physical work does not include preliminary work such as planning, design or licensing activities. The safe harbor is available if the taxpayer incurs five percent or more of the total cost of a facility before 1/1/14, and the taxpayer makes continuous progress towards completion of the facility as indicated by relevant facts and circumstances specified in the notice.

- Woe to the taxpayer who incurs cost overruns so that the pre-1/1/14 expenses do not amount to the requisite five percent. The safe harbor is not satisfied if total costs of the facility cause the amount incurred before 1/1/14, to be less than five percent of total cost. However, the credits may be claimed on some but not all of the facilities constituting a single project.

a. Further guidance on continuous progress towards completion and transfers of facilities. Notice 2013-60, 2013-44 I.R.B. 431 (9/20/2013). Among other issues, this notice addresses (1) the determination of whether a taxpayer makes continuous progress towards completion for purposes of the significant physical work test and the five percent safe harbor, and (2) the effect of transfers of a facility. The notice provides that a facility will be considered to satisfy the continuous progress towards completion requirement if the facility is placed in service before January 1, 2016. If a facility is not placed in service before January 1, 2016, whether the facility satisfies this requirement will be determined by the relevant facts and circumstances. Regarding transfers, the notice provides that, if a qualified facility satisfies either the significant physical work test or the five percent safe harbor, a taxpayer that owns the facility during the 10-year period beginning on the date the facility was originally placed in service may claim the production tax credit with respect to that facility even if the taxpayer did not own the facility at the time construction began. "Alternatively, a taxpayer that owns the facility on the date it is originally placed in service may elect to claim the ITC in lieu of the PTC with respect to that facility even if the taxpayer did not own the facility at the time construction began."

b. Even more guidance on when construction begins. Notice 2014-46, 2014-35 I.R.B. 520 (8/8/14). This notice (1) clarifies how taxpayers satisfy the physical work test, and (2) addresses the effect of various types of transfers with respect to a facility after construction has begun. The notice also "modifies the application of the Safe Harbor for certain facilities with respect to which a taxpayer paid or incurred less than five percent, but at least three percent, of the total cost of the facility before January 1, 2014."

4. Taxpayers now can make the alternative simplified research credit election on an amended return. T.D. 9666, Alternative Simplified Credit Election, 79 F.R. 31863 (6/3/14). Section 41(c)(5) provides a "simplified" research credit of 14 percent of so much of the qualified research expenses as exceeds 50 percent of the average qualified research expenses for the three preceding taxable years, or, if the taxpayer has no qualified research expenses in any of the three prior years, the simplified credit is 6 percent of qualified research expenses for the year. (The regular credit under § 41(a)(1) generally is 20 percent of qualified research expenses over a base.) Final regulations as amended in 2011 require that an election for the alternative simplified credit (ASC) be made with the return filed for the year to which the election applies, provide that the election may not be made on an amended return, and state that the IRS will not grant an extension of time to file the election under Reg. § 301.9100-3. T.D. 9528, Alternative Simplified Credit Election, 76 F.R. 33994 (6/10/11). In response to taxpayer requests, Treasury and the IRS have removed from the final regulations the rule in Reg. § 1.41-9(b)(2) that prohibits a taxpayer from making an ASC election for a tax year on an amended return. In place of this rule, temporary regulations provide that taxpayers can make an ASC election for a tax year on an amended return. However, because of concerns that permitting changes from the regular credit to the ASC on amended returns could result in more than one audit of a taxpayer's research credit for a tax year, the temporary regulations provide that a taxpayer that previously claimed, on an original or amended return, a § 41 credit for a tax year may not make an ASC election for that tax year on an amended return. A taxpayer that is a member of a controlled group in a tax year may not make an ASC election for that tax year on an amended return if any member of the controlled group for that year previously claimed the research credit using a method other than the ASC on an original or amended return for that tax year. The regulations generally apply to elections with respect to tax years ending on or after 6/3/14, but taxpayers can rely on the temporary regulations to make elections for prior tax years if the election is made before the period of limitations for assessment of tax has expired for that year.

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

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

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

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

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

G. **Natural Resources Deductions & Credits**

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

1. **It's now impossible as a matter of law to abandon a capital asset. W(h)ither the "sale or exchange" requirement.** Pilgrim's Pride Corp. v. Commissioner, 141 T.C. No. 17 (12/11/13). In 1999, the taxpayer purchased certain stock and securities issued by Southern States Cooperative for $98.6 million. In 2004, Southern States offered to redeem the stock and securities for less than the taxpayer had paid for them. The taxpayer wanted approximately $39 million, but Southern States was willing to pay only $20 million. The negotiations ended without an agreement and the taxpayer "abandoned" the securities and claimed a $98.6 million ordinary loss deduction. The IRS disallowed the ordinary loss deduction and treated the loss as capital. The Tax Court (Judge Dawson) upheld the IRS's position. The stock and securities were capital assets and § 1234A required that the loss be treated as capital. Section 1234A provides that:

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

- Judge Dawson reasoned that "[s]hares of stock are intangible interests or rights that the owner has in the management, profits, and assets of a corporation, while the certificate of stock is tangible evidence of the stock ownership of the person designated therein and of the rights and liabilities resulting from such ownership," and that Congress intended "section 1234A to [apply to] terminations of all rights and obligations with respect to property that is a capital asset in the hands of the taxpayer or would be if acquired by the taxpayer, including not only derivative contract rights but also property rights arising from the ownership of the property."

- The court rejected the taxpayer's argument that an ordinary loss was allowable under Reg. § 1.165-2(a), because Reg. § 1.165-2(b) disallowed the loss as the surrender of the stock and securities was deemed to be a loss from a sale or exchange of a capital asset pursuant to § 1234A. It also noted that Rev. Rul. 93-80, 1993-2 C.B. 239, which allowed an ordinary loss deduction upon the abandonment of a partnership interest in a partnership that had no debt, was issued four years before § 1234A was amended in 1997 to apply to all property that is (or would be if acquired) a capital asset in the hands of the taxpayer, and thus it did not carry any weight.

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

3. Seventy months in the slammer, a $19 million fine, and a $44 million forfeiture for insider trading was penalty enough. Nacchio v. United States, 115 Fed. Cl. 195 (3/12/14). The taxpayer was the CEO of Qwest Communications International when he realized profits of approximately $44 million trading Qwest stock. He was convicted of insider trading, paid a fine of $19 million and forfeited $44 million that was paid over to victims of his securities fraud scheme. (He also was sentenced to 70 months in prison.) On a motion for summary judgment, the Court of Claims (Judge Williams) held that the $44 million forfeiture was deductible under § 165. Because the forfeiture served to compensate victims of the taxpayer's securities fraud, the payment was not a "fine or similar penalty" that is not deductible pursuant to § 162(f). The court rejected the government's argument that allowing a deduction under § 165 would frustrate public policy, reasoning that "[a]llowing the deduction would not increase the odds in favor of insider trading or destroy the effectiveness of the securities laws." Furthermore, "[d]isallowing the deduction would result in a 'double sting' by requiring the taxpayers to both make restitution and pay taxes on income they did not retain." However, whether § 1341 applied required further proceedings because there was a material question of fact whether Nacchio, who did not plead guilty, believed that he had an unrestricted right to the profits in the year he realized them.

I. At-Risk and Passive Activity Losses

1. Judge Morrison finds an honest taxpayer. Montgomery v. Commissioner, T.C. Memo. 2013-151 (6/17/13). Temp. Reg. § 1.469-5T(f)(4) provides that the extent of an individual's participation in an activity may be established by any reasonable means. "'Reasonable means' ... include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." However, "contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means." In the instant case, however, Judge Morrison held that material participation had been established without any such documentary evidence being introduced. The taxpayers established material participation by their credible testimony providing details of the nature of the activities they conducted in starting and managing a business. They founded the company, negotiated contracts, hired 250 employees, and conducted daily business, "work[ing] on the business 'day in and day out.'"

- This case is notable because in most cases claims of material participation without written documentation fall on deaf ears in the courts. *See, e.g., Bailey v. Commissioner*, T.C. Memo. 2001-296 (2001) (log book of visits to rental real estate that did not include contemporaneous record of hours devoted to real estate activity was not sufficient to substantiate that taxpayer devoted requisite number of hours to real estate business; uncorroborated estimates of hours required to perform activities were unreliable because they were prepared years later in anticipation of litigation); *D'Avanzo v. United States*, 67 Fed. Cl. 39 (2005) (taxpayer did not offer contemporaneous written record of number of hours he spent performing personal services with respect to rental properties; noncontemporaneous log book of hours claimed to have been devoted to real estate activities and testimony at trial, alone, are inadequate evidence to establish that taxpayer devoted requisite number of hours to real estate business activities), *aff'd by order*, 215 Fed. Appx. 996 (Fed. Cir. 2007); *Lee v. Commissioner*, T.C. Memo. 2006-193 (2006) (full-time physician and full-time IRS employee could not establish that they worked more than one half of their time in their real estate partnership business; noncontemporaneous time logs submitted at trial that more than doubled hours in log books submitted during audit were not credible); *Goolsby v. Commissioner*, T.C. Memo. 2010-64 (2010) (activity log purporting to document hours of management activity was not credible; it was created after taxpayer's return was selected for audit and solely for purposes of the case; taxpayer had no contemporaneous records, such as appointment books, calendars, or narrative summaries to support activity log; "[i]ncredibly, the ... activity log lists days during which [the taxpayer] allegedly logged more than 24 hours of work").

a. **A "ballpark guesstimate" doesn't let you sing ♫♪ Yankee Doodle Dandy♫♪.** Merino v. Commissioner, T.C. Memo. 2013-167 (7/16/13). The Tax Court (Judge Wherry) held that the taxpayer failed to prove that he was a real estate professional who materially participated in a real property rental activity, thereby escaping the passive activity loss limitations by way of § 469(c)(7). The taxpayer's only evidence was his own "summary of hours" that was prepared "using his estimates and his memory as to how much time he spent on certain tasks with respect to the real estate rental activity." It "was not created from contemporaneous documentation, but rather it [was] a postevent reconstruction from memory," that was "less of an approximation and more of a 'ballpark guesstimate.'"

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

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

d. **Who needs a log book? Material participation established under the "facts and circumstances" test without counting hours—quality is more important that quantity.** Wade v. Commissioner, T.C. Memo. 2014-169 (8/20/14). The husband and wife taxpayers owned stock in two S corporations that passed through to them losses. The IRS disallowed the losses as passive activity losses subject to § 469. The record established that Mr. Wade spent "over 100 hours participating in TSI and Paragon during 2008, and his participation consisted primarily of nonmanagement and noninvestment activities," while his son managed the day-to-day operations of the companies. Mr. Wade focused on product development and customer retention. The Tax Court (Judge Goeke) found that Mr. Wade's "efforts were continuous regular, and substantial ... Mr. Wade brought something to [the companies] that no one else could have, and they could not have continued to operate without his contacts and expertise." Accordingly, pursuant to the "facts and circumstances" test in Reg. § 1.469-5T(a)(7), which requires participation on a "regular, continuous, and substantial basis" during the year, Mr. Wade materially participated in the companies' activities. That the record did not establish that Mrs. Wade actively participated in the companies was irrelevant because Reg. § 1.469-5T(f)(3) provides that participation by a married taxpayer is treated as participation by his or her spouse. Thus, Mr. Wade's material participation in the companies was sufficient to establish material participation for Mrs. Wade.

2. Some questions about whether a trust can be a real estate professional have been answered, others have not. Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (3/27/14). The taxpayer trust owned a single-member LLC that was a disregarded entity conducting an extensive rental real estate business. Three of the six trustees were full time employees of the LLC; three of the trustees had little or no involvement in the real estate business. The rental real estate business incurred substantial losses, which the trust deducted against income and gains from non-passive activities. The IRS disallowed the losses as passive activity losses, but the trust argued that it qualified as a real estate professional under § 469(c)(7). The Tax Court (Judge Morrison) rejected the IRS's argument that, except as expressly provided for closely held C corporations in § 469(c)(7)(D)(i), § 469(c)(7) applies only to individual taxpayers. He reasoned that notwithstanding language in Reg. § 1.469-9(b)(4), which deals with § 469(c)(7), that defines "[p]ersonal services" as "work performed by an individual in connection with a trade or business," the definition of "material participation" in § 469(h) is not so limited. Even though the statute does not provide any rule for how material participation by a trust is determined, and no regulations doing so have been promulgated, nothing in the statute or legislative history limited the application of § 469(c)(7) to individuals and closely held corporations. The IRS further argued that even if § 469(c)(7) could apply to trusts, (1) in determining whether a trust is materially participating in an activity, only the activities of the trustees can be considered and the activities of that trust's employees must be disregarded, and (2) neither the participation by the trustees in their capacity as employees of the LLC nor the work of 20 or so non-trustee employees counted toward material participation. Judge Morrison also rejected this argument. Even if the activities of the trust's non-trustee employees were disregarded, the activities of the trustees were properly considered in determining whether the trust materially participated in the real-estate operations, including their activities as employees of the LLC. On all of the facts, including that two of the trustees "were involved in managing the day-to-day operations of the trust's various real-estate businesses," the trust materially participated in its real-estate operations. Finally, because the IRS limited its arguments to (1) trusts are categorically barred from qualifying under the § 469(c)(7) exception, and (2) the trust did not materially participate in real-property trades or businesses, the court expressly did not address whether (1) more than one-half of the personal services performed in trades or businesses by the trust were performed in real-property trades or businesses, and (2) the trustees performed more than 750 hours of services during the year in the real-property trades or businesses. Accordingly, the trust's rental activities were not passive activities.

3. An LLC member guarantees debt of the LLC incurred in connection with an aircraft leasing activity and successfully flies around the at risk and passive activity loss rules. Moreno v. United States, 113 A.F.T.R.2d 2014-2149 (W.D. La. 5/19/14). The taxpayer claimed a $4.7 million loss arising from the acquisition and leasing of a Learjet aircraft by a disregarded LLC of which he was the sole member. The LLC acquired the aircraft with a loan secured by the aircraft. The loan was guaranteed by both the taxpayer and Dynamic Industries, Inc. (Dynamic), a wholly owned subsidiary of a corporation of which the taxpayer held 98 percent of the stock. The LLC leased the aircraft to six lessees during the tax year in question. The government argued that the taxpayer was not at risk with respect to the aircraft leasing activity. The government conceded that the taxpayer's personal guaranty satisfied § 465(b)(2)(A), which states that a taxpayer is at risk for amounts borrowed for use in an activity to the extent the taxpayer "is personally liable for the repayment of such amounts." Instead, the government argued that the taxpayer was not at risk by virtue of § 465(b)(4), which provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." The court (Judge Doherty) observed that the Fifth Circuit, to which this case is appealable, has not addressed the applicable standard for determining whether a taxpayer is protected against loss within the meaning of § 465(b)(4) and that the majority of Circuits (the Second, Eighth, Ninth, and Eleventh) have adopted an "economic realities" test while the Sixth Circuit has adopted a "payor of last resort" test. The court concluded that, under either test, the taxpayer was not protected against loss within the meaning of § 465(b)(4) and was at risk. "Simply put," the court reasoned, "the failure of [the LLC] to meet the terms of its loan agreement would trigger a demand for payment by [the lender] against Dynamic and/or Moreno." In reaching this conclusion, the court rejected the government's arguments that (1) the taxpayer did not have sufficient liquidity to pay the loan in the event of the LLC's default ("the government has cited no legal authority 'that a guarantor must have unencumbered cash or marketable resources to satisfy a claim under a guaranty to be at risk'"); (2) the lender's internal documents showed that it relied on Dynamic, rather than the taxpayer, to pay the loan upon the LLC's default ("the government has cited no legal authority in support of its position that where a lender's internal loan documents purportedly show the lender is relying upon the financial strength of one surety over another surety, the latter surety is no longer to be given 'at risk' treatment under section 465, because the foregoing scenario constitutes protection from loss under either the payor of last resort test or the economic reality test"); (3) the taxpayer, as the ultimate controlling shareholder of Dynamic, would ensure that Dynamic paid the loan ("the government's speculative assertion … is insufficient to show Moreno engaged in a prohibited loss-limiting arrangement"); (4) the taxpayer was protected by an indemnity provision in his employment agreement with the parent corporation of Dynamic ("the indemnity provision … is [not] sufficiently broad in scope, such that it applies to Moreno's *personal* guaranty of the [LLC's] loan"); and (5) if Dynamic were to pay the loan, it would have no right to recover any of its payment from the taxpayer. However, in addressing the government's fifth argument, the court concluded that the taxpayer and Dynamic each would have a right of contribution against the other if they paid the loan, and therefore the taxpayer was at risk for only 50 percent of the amount guaranteed.

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

> Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals thereof) is treated for purposes of this paragraph (e)(3)(iii) as a separate period of customer use.

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

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

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

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Just because you're a good guy who helps the government recover tens of millions of dollars of fraudulent Medicare claims doesn't punch your ticket to the promised land of capital gains. Patrick v. Commissioner, 142 T.C. No. 5 (2/24/14). The taxpayer filed several *qui tam* complaints under the False Claims Act, alleging that his employer defrauded the government by improperly marketing medical equipment as requiring in-patient rather than out-patient treatment and that certain medical providers billed treatments under Medicare as in-patient expenses. The cases were settled for over $75 million and the government intervened. The taxpayer received a relator's share totaling over $6.8 million, which he reported as capital gain. The IRS treated the relators' awards as ordinary income. The Tax Court (Judge Kroupa) sustained the deficiency, rejecting the taxpayer's argument that the FCA gives rise to a contract under which the relator sells information to the government in exchange for a share of the recovery. First, there was no sale or exchange of information. "The Government does not purchase information from a relator under the FCA. Rather, it permits the person to advance a claim on behalf of the Government. The award is a reward for doing so. No contractual right exists." Second, the information provided to the government was not a capital asset. "The ordinary income doctrine excludes from the definition of a capital asset 'property representing income items or accretions to the value of a capital asset themselves properly attributable to income.'" The taxpayer "did not receive a right to the relator's share in exchange for an underlying investment of capital." The right to income was a reward, which is ordinary income. Finally, the information the taxpayer gave to the government was not a capital asset because it was not property. The information could not be property because the taxpayer did not have a legal right to exclude others from its use and enjoyment. The False Claims Act obligated him to turn over all supporting documentation to the government, and the taxpayer had no right to prevent his employer or medical providers from using or disclosing the information.

2. "Bitcoin is not a currency." "No surprise" says Professor Omri Marian.[6] Notice 2014-21 2014-16 I.R.B. 938 (3/25/14). This Notice "describes how existing general tax principles apply to transactions using virtual currency." The notice has two main components: (1) a substantive part (i.e., how Bitcoin transactions should be taxed), and (2) an information reporting part (i.e., how income on Bitcoin transactions should be reported and how tax can be collected).

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

(1) Bitcoin is *not* a currency for tax purposes; it is property. As such, gain and losses on the disposition of Bitcoins can never be "exchange gain or loss." I.R.C. § 988. This may come as a disappointment to taxpayers who lost money in Bitcoin investments and may have hoped to have the losses classified as exchange-losses, and, as such, as ordinary losses. On the other hand, taxpayers who have disposed of appreciated investment positions in Bitcoins may enjoy capital gains treatment. Taxpayers who hold Bitcoin as inventory will be subject to ordinary gains and losses upon disposition.

(2) The receipt of Bitcoins in exchange for goods and services is taxable at the time of receipt. The amount realized is the U.S. dollar value of the Bitcoins received. The disposition of Bitcoins in exchange for goods and services is a realization and recognition event to the extent the value of Bitcoin has changed since the time it was acquired. Thus, if a taxpayer bought 1 Bitcoin for $500, and later used 1 Bitcoin to purchase a TV when Bitcoin was trading at $600, the taxpayer has a taxable gain of $100.

- This part of the Notice has attracted some criticism from several commentators. A New York Times article summarized this critique, noting that characterizing Bitcoin as property "could discourage the use of Bitcoin as a payment method. If a user buys a product or service with Bitcoin, for example, the IRS will expect the individual to calculate the change in value from the date the user acquired a Bitcoin to the date it was spent. That would give the person a basis to calculate the gains—or losses—on what the IRS is now calling property." This criticism is partially justified, although the result would have generally been the same had the IRS decided to classify Bitcoin as a foreign currency. Under current law, U.S. taxpayers whose functional currency is the U.S. dollar (practically all U.S. taxpayers), must track their basis in any foreign currency they hold, and recognize exchange gain or loss as soon as they dispose of the currency, but only to the extent their exchange gain or loss exceeds $200. Thus, the

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

criticism might have some merit, as capital gains or losses are taxed from the first dollar, while exchange gain or losses are subject to the $200 threshold. I.R.C. § 988(e). This could be corrected if a de minimis threshold would be made applicable to Bitcoin transactions as well, but it is not clear that there is any legal basis for the IRS to do so. The only way to completely avoid taxation upon disposition of Bitcoin is to characterize it as a functional currency, which could only conceivably happen if the U.S. adopts Bitcoin as a legal tender. This is much to ask for, and certainly not within the power of the IRS to decide.

(3) Since taxes are paid in U.S. Dollars and not in Bitcoins, the Bitcoin value must be converted to U.S. dollars for purposes of determining gains and losses. Fair market value is determined by reference to the BTC/USD price quoted in an online exchange if "the exchange rate is established by market supply and demand." The problem with this determination is that there are multiple such exchanges, and the BTC/USD spot price may vary significantly among such exchanges. In March, 2013, the price difference between various exchanges varied by as much as $100, for an average trading price across exchanges of about $575. Taxpayers could cherry-pick their BTC/USD exchange rate and reduce tax gains or increase tax losses. The Notice prescribes that BTC to USD conversion must be made "in a reasonable manner that is consistently applied." It is not clear what "consistency" means in this context and more guidance on this issue is needed.

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

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

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

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

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

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

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

3. In complex transactions involving securities and money market mutual fund shares, the taxpayer was not required to show an "actual economic loss" to deduct losses, but was required to allocate basis between income interests and residual interests to calculate gain or loss on the interests sold. Principal Life Insurance Co. v. United States, 116 Fed. Cl. 82 (5/9/14). The taxpayer engaged in two types of transactions. First, the taxpayer purchased residual interests in money market mutual fund shares from six separate sellers in eight separate transactions. In each transaction the selling financial institution retained a carved-out income interest in the underlying money market shares, which constituted all dividends paid in connection with the money market shares for a period of between 20 and 23 years. The transaction was actually more complex and both the taxpayer and the sellers held their beneficial interests through trusts. In the second set of transactions, the taxpayer purchased a portfolio of eight to ten perpetual floating-rate securities from third parties in the secondary market and sold the residual interests while retaining carved-out income interests. It transferred the residual interests to a trust and allocated all of its tax basis in each underlying perpetual security to the corresponding Principal Certificate — even though the Interest Certificate reflected 80 percent of the cost of the overall security. The taxpayer then claimed a loss on the sale of the residual interests. The IRS disallowed the loss on the second set of transactions and included in the taxpayer's income the current interest income on the first set of transactions. The taxpayer paid and pursued a refund. The Court of Claims (Judge Allegra) granted the government's motion for partial summary judgment and denied the taxpayer's claim, although he rejected the government's argument that the loss was disallowed because § 165(a) "requires that there be an 'actual economic loss' before a deduction is permitted," rejecting the government's reasoning that such was the import of Reg. § 1.165-1(b), which states that "[o]nly a bona fide loss is allowable." Instead, the court held that the basis apportionment rule of Reg. § 1.61-6(a) applied to allocate basis between the retained income interests and the transferred residual interests, rejecting the taxpayer's argument that case law provided an exception to Reg. § 1.61-6(a) for carved out income interests. Because the loss deduction was based upon a basis allocation that was erroneous as a matter of law, and since the taxpayer offered no alternative to its failed argument, summary judgment for the government was entered on the loss issue. Alternatively, the loss was disallowed on the ground that the complex transaction—which defies a summary description—by which the residual interests were transferred to the trust was a transfer to a partnership (relying on Reg. § 301.7701-4(c)(1), dealing with investment "trusts" in which there is a power to vary the interests of the beneficial owners) in exchange for a partnership interest to which § 721 applied. As for the first set of transactions, the court again found the trusts actually to be partnerships under Reg. § 301.7701-4(c)(1) and that a portion of the partnership income should have been allocated to the taxpayer as a partner. Although the return position was erroneous, factual issues remained for trial.

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

4. You can't have your cake and eat it too! Debough v. Commissioner, 142 T.C. No. 17 (5/19/14). This case involves the interplay between § 121 and § 1038, which provides rules for computing gain when a seller repossesses real property in satisfaction of a debt secured by that real property. The taxpayer and his wife sold their primary residence in 2006 pursuant to an installment sale agreement. The buyers' debt was secured by a mortgage on the home. The price was $1,400,000 and the taxpayers recognized a gain of $657,796. The taxpayers properly excluded $500,000 in gain on the sale. They calculated the gain reportable in each year by (1) excluding $500,000 of gain pursuant to § 121, (2) calculating their gross profit percentage by dividing the $157,796 in remaining gain ($657,796–$500,000 = $157,796) by the $1,400,000 sale price exclusive of commissions and other costs of sale, and (3) multiplying the gross profit percentage by the amount of money received. In total, the taxpayer (his wife having died in 2006) received payments of $505,000 and reported $56,920 in gain over the course of 2006, 2007, and 2008. In 2009 the buyers defaulted and the taxpayer reacquired the property. He treated his reacquisition of the property in 2009 as a reacquisition of property in full satisfaction of indebtedness under § 1038 and recognized $97,153 in the form of long-term capital gains related to the reacquisition of the property. The IRS asserted that the long-term capital gain the taxpayer was required to recognize on the reacquisition of the property included the $500,000 that he had previously excluded under § 121. The Tax Court (Judge Nega) agreed with the IRS, holding that the gain recognized on the reacquisition of the property included gain previously excluded under § 121. Generally speaking, under § 1038 if the seller of real property receives the buyer's purchase money debt obligation and the seller reacquires the property in partial or full satisfaction of the buyer's debt, the seller does not recognize gain or loss upon the reacquisition, except, as provided in § 1038(b), to the extent he has received money or other property that exceeds the amount of gain reported before the reacquisition. (The special exception to the general rule in § 1038(e) was inapplicable because the taxpayer had not resold the residence within one year after its reacquisition.) Because the taxpayer had received $505,000 in cash before the reacquisition and had both the cash and the house as a result of the reacquisition, he was "actually in a better position than he was before the sale by virtue of having ownership over both the property and $505,000."

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

6. What! You mean my money market fund might lose money — an exception from the wash sale rules for money market fund losses. Rev. Proc. 2014-45, 2014-34 I.R.B. 388 (7/23/14). This revenue procedure (proposed as a de minimis rule in Notice 2013-48, 2013-31 I.R.B. 120 (7/3/13)) provides a complete exception to the § 1091 wash sale rules for certain redemptions of shares of money market funds (MMFs) that, under SEC regulations, do not maintain a constant share price. It applies to a redemption of one or more shares in an investment company registered under the 1940 Act if— (1) the investment company is regulated as an MMF under SEC Rule 2a–7 and holds itself out to investors as an MMF; and (2) at the time of the redemption, the investment company is a floating-NAV[7] MMF. If a redemption of shares in an MMF to which the revenue ruling applies results in a loss, the IRS will not treat the redemption as part of a wash sale. Section 1091(a) will not disallow the deduction for the resulting loss in the year realized and § 1091(d) will not cause the basis of any property to be determined by reference to the basis of the redeemed shares. In the revenue procedure previously proposed in Notice 2013-48, a loss was not subject to the wash sale rules if a taxpayer realized a loss upon a redemption of shares in a floating-NAV MMF and the amount of the loss was not more than 0.5 percent of the taxpayer's basis in the shares; in contrast, this revenue procedure completely exempts floating-NAV MMFs from the wash sale rules of § 1091.

a. A simplified method of accounting for gains and losses in shares of money market funds that do not maintain a constant share price. REG-107012-14, Method of Accounting for Gains and Losses on Shares in Certain Money Market Funds; Broker Returns With Respect to Sales of Shares in Money Market Funds, 79 Fed. Reg. 43694 (7/28/14). These proposed regulations provide a simplified method of accounting for gains and losses on shares of floating-NAV MMFs. Under this method, gain or loss is based on the change in the aggregate value of the shares in the floating-NAV MMF during a computation period (which may be the taxpayer's taxable year or certain shorter periods) and the net amount of the purchases and redemptions during the period. For example, if the MMF shares held by a calendar-year individual have a value of $1 million on January 1, a closing value on December 31 of $1.1 million, and if during the year the taxpayer purchases additional shares for $50,000 and has shares redeemed for $40,000, the taxpayer's gain for the year would be $90,000 ($100,000 change in value minus $10,000 net amount of purchases and redemptions). The character of the taxpayer's gain or loss depends on the character of the underlying MMF shares in the taxpayer's hands. The simplified method of accounting does not change the tax treatment of dividends received. A taxpayer that adopts the simplified method of accounting will not need to take advantage of the exception from the wash sale rules provided in Rev. Proc. 2014-45, 2014-34 I.R.B. 388 (7/23/14), because under the simplified method net gain or loss is determined for each computation period, and no gain or loss is determined for any particular redemption of a taxpayer's shares in a floating-NAV MMF. Once a taxpayer has adopted a method of accounting for gains and losses on shares in floating-NAV MMFs, any change from that method (including a change to or from the simplified method) is a change in method of accounting to which the provisions of § 446 and the accompanying regulations apply. The proposed regulations concerning the simplified method are proposed to apply to taxable years ending on or after the date final regulations are published in the Federal Register, but shareholders of floating-NAV

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

MMFs can rely on the proposed regulations for taxable years ending on or after 7/28/14 and beginning before the date final regulations are published in the Federal Register.

7. "A 'transferor's acts … speak louder than his words in establishing whether a sale of a patent has occurred.'" Cooper v. Commissioner, 143 T.C. No. 10 (9/23/14). The taxpayer was an engineer-inventor who transferred several patents to a corporation 24 percent of the stock of which he owned. His wife's sister and a friend owned the remaining stock. The corporation and its shareholders entered into a stock restriction agreement providing that shares could not be sold, assigned, or transferred except according to the terms of the stock restriction agreement. Under the agreement, the taxpayer was permitted to transfer shares to his issue or any trust for their benefit. The two other shareholders were permitted to transfer shares only to another shareholder. In consideration of the transfer, the taxpayer received a royalty, and he claimed that the royalty receipts were entitled to capital gain treatment under § 1235. Section 1235(a) provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent by any holder will be treated as the sale or exchange of a capital asset held for more than one year, regardless of whether the payments in consideration of such transfer are contingent on the productivity, use, or disposition of the property transferred. Based on the record, the Tax Court (Judge Marvel) found that substantially all of the corporation's decisions regarding licensing, patent infringement, and patent transfers were made either by the taxpayer or at his direction. The taxpayer controlled the corporation in all material respects. The other two shareholders acted in their capacities as directors and officers at the taxpayer's direction. They did not make independent decisions in accordance with their fiduciary duties or act in their best interests as shareholders. The court upheld the IRS's treatment of the royalty as ordinary income, even though § 1235(d) did not apply to deny capital gain treatment. (Under § 1235(d), transfers between related persons, as defined in § 267(b), are not eligible for capital gain treatment, and for purposes of § 1235, a corporation and an individual owning 25 percent or more of the stock of such corporation directly or indirectly are related persons.) Neither the Code nor regulations address whether § 1235 "applies to transfers to a corporation that is not related to the holder but is indirectly controlled by the holder," and "[w]hether a holder's control over a corporate transferee that is unrelated (within the meaning of section 1235(d)) defeats capital gain treatment" was an issue of first impression for the Tax Court. However, ***Charlson v. United States***, 525 F.2d 1046 (Ct. Cl. 1975), considered this issue and concluded that such control could prohibit the transfer of substantially all rights in a patent and therefore preclude capital gain treatment under § 1235. The Tax Court agreed with the holding of ***Charlson***, "that retention of control places the holder in essentially the same position as if the patent had not been transferred, thereby precluding the application of section 1235," and "that Congress intended for a 'transferor's acts to speak louder than his words in establishing whether a sale of a patent has occurred.'" Accordingly, it held that "retention of control by a holder over an unrelated corporation can defeat capital gain treatment under section 1235 because the retention prevents the transfer of 'all substantial rights' in the patent." Analyzing the record the court concluded that the corporation was not independent of the taxpayer and thus the taxpayer had not transferred all substantial rights in the patents to the corporation as required to obtain capital gain treatment under § 1235(a).

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

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

8. It's alchemy—a frustrated intent to earn ordinary income magically turns into capital gain. Long v. Commissioner, 114 A.F.T.R.2d 2014-6657 (11th Cir. 11/20/14), *aff'g in part and rev'g in part*, T.C. Memo 2013-233. The taxpayer owned the stock of a corporation (LOTC), which had the right to purchase land from another party under a purchase and sale agreement. The taxpayer, through his corporation, planned to build a condominium on the land. The seller refused to perform, and LOTC sued the seller and obtained a court order for specific performance. Rather than LOTC purchasing the property, the taxpayer (not LOTC) "sold his position as plaintiff" in the suit for $5,750,000. (The IRS and Long stipulated that notwithstanding the interposition of LOTC, which had no employees, no TIN, and never filed a tax return, Long was at all times acting as an unincorporated sole proprietor.) The Tax Court held that the proceeds of the sale of the contract were ordinary income, but the Eleventh Circuit reversed on this issue, holding that the proceeds were capital gain. According to the Court of Appeals, the Tax Court erred by treating the land itself, which the taxpayer intended to develop and sell in the ordinary course of business, as the property that the taxpayer sold (which is indeed what the Tax Court did), when it was clear that he "did not sell the land itself, but rather his right to purchase the land, which is a distinct contractual right that may be a capital asset." Thus, "[t]he dispositive inquiry [was] not 'whether Long intended to sell the land to customers in the ordinary course of his business,' but whether Long held the exclusive right to purchase the property 'primarily for sale to customers in the ordinary course of his trade or business.'" Because there was no evidence that the taxpayer had any "intent to assign his contractual rights in the ordinary course of business, or to obtain the judgment for the purpose of selling it in ordinary course of business, the gain was capital gain. Furthermore, the gain was long term capital-gain because the "property" that was sold was the right to purchase the land, which originally arose from the purchase contract, not the state court judgment in the specific performance suit. Finally, the court rejected the IRS's argument that the sales proceeds were ordinary income under the "substitute for ordinary income" doctrine. The court reasoned as follows:

> It cannot be said that the profit Long received from selling the right to attempt to finish developing a large residential project that was far from complete was a substitute for what he would have received had he completed the project himself. Long did not have a future right to income that he already earned. By selling his position in the litigation, Long effectively sold Ferris his right to finish the project and earn the income that Long had hoped to earn when he started the project years prior. Taxing the sale of a right to create—and thereby profit—at the highest rate would discourage many transfers of property that are beneficial to economic development.
>
> Long possessed a "bundle of rights [that] reflected something more than an opportunity ... to obtain periodic receipts of income." *Comm'r v. Ferrer*, 304 F.2d 125, 130–31 (2d Cir.1962) ... . Long's profit was not "simply the amount [he] would have received eventually, discounted to present value." *Womack*, 510 F.3d at 1301. Rather, Long's rights in the LORH property represented the potential to earn income in the future based on the owner's actions in using it, not entitlement to the income merely by owning the property. ... We have already held that selling a right to earn future undetermined income, as opposed to selling a right to earned income, is a critical feature of a capital asset. *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 59 (5th Cir. 1963). The fact that the income earned from developing the project would otherwise be considered ordinary income is immaterial.

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

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

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

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

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

F. Section 1033

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

G. Section 1035

H. Miscellaneous

1. No depositors, no regulation, no "bank," no bad debt deduction for worthless asset-backed securities. An otherwise profitable victim of the financial meltdown can't deduct any of over $500,000,000 of losses on asset-back securities. This one ain't funny. MoneyGram International, Inc. v. Commissioner, 144 T.C. No. 1 (1/7/15). MoneyGram's core business is to provide consumers and financial institutions with payment services that involve the movement of money through three main channels: money transfers, money orders, and payment processing services. MoneyGram derives its revenue from the transaction fees paid by its customers and from management of currency exchange spreads on international money transfers. When a customer purchases a money order by giving cash to a MoneyGram agent, the agent must remit these funds to MoneyGram immediately. However, MoneyGram typically enters into agreements with its agents allowing them to retain and use these funds for an agreed-upon period. MoneyGram also derives revenue from the temporary investment of funds remitted from its financial institution customers until such time as the official checks and money orders clear. MoneyGram is not subject to regulation as a bank and it has never been regulated as a bank by any Federal banking regulator. On its 2007 and 2008 Forms 1120, MoneyGram classified its business as "nondepository credit intermediation." During 2007 and 2008, MoneyGram undertook a recapitalization that included writing down or writing off a substantial volume of partially or wholly worthless securities. MoneyGram claimed ordinary § 166(a) bad debt deductions with respect to the partial or complete worthlessness of hundreds of millions of dollars of non-REMIC asset-backed securities in which it had invested those securities. (Treating these losses as capital losses would have generated no current tax benefit for MoneyGram because it had no capital gain net income during 2007 and 2008 against which capital losses could be offset.) The IRS determined that these securities were "debts evidenced by a security" under § 165(g)(2)(C) and that MoneyGram was entitled to ordinary bad debt deductions (via § 582(a)), as opposed to capital losses, only if it were a "bank" within the meaning of § 581, that MoneyGram was not a "bank"; thus the IRS disallowed the bad debt deductions. The Tax Court (Judge Lauber) upheld the deficiency. To qualify as a "bank" under § 581, a taxpayer must meet three distinct requirements. First, it must be "a bank or trust company incorporated and doing business" under Federal or State law. Second, "a substantial part" of its business must "consist[] of receiving deposits and making loans and discounts." Third, it must be "subject by law to supervision and examination" by federal or state authorities having supervision over banking institutions. Under this test, during 2007 and 2008 MoneyGram did not qualify as a "bank" because it did not display the essential characteristics of a bank as that term is commonly understood and because a substantial part of its business did not consist of receiving bank deposits or making bank loans. Because MoneyGram was not a "bank" within the meaning of § 581, it was ineligible to claim ordinary loss deductions on account of the worthlessness of its securities under § 582. The losses were capital losses.

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. The Supreme Court will consider the legality under the Religious Freedom Restoration Act of the application of Obamacare's contraceptive mandate to

closely held businesses owned by persons who claim their Christian beliefs would be violated by compliance with that mandate. Hobby Lobby Stores, Inc. v. Sibelius, 723 F.3d 1114 (10th Cir. 6/27/13) (*en banc*), *cert. granted*, 134 S. Ct. 678 (11/26/13). The Tenth Circuit (Judge Tymkovich) held that the Religious Freedom Restoration Act (P.L. 103-141) protects closely held family businesses operated in corporate form from violating their owners' Christian principles by complying with a regulation under the PPACA (Obamacare) that requires them to provide drugs and devices that they believe are abortifacients as part of their employer-sponsored health care plans.

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

b. The Supreme Court affirmed the Tenth Circuit based upon the Religious Freedom Restoration Act. The dissenting justices would require religious principles to give way to female employees' regulatory rights to have all twenty contraceptive services, including the four that may or may not be abortifacients. Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751 (6/30/14) (5-4), *aff'g* Hobby Lobby Stores, Inc. v. Sibelius, 723 F.3d 1114 (10th Cir. 6/27/13) (*en banc*). Justice Alito's majority opinion was based upon the Religious Freedom Restoration Act, which requires that requirements of general applicability that substantially burden a person's exercise of religion must (1) be in furtherance of a compelling governmental interest, and (2) be the least restrictive means of furthering that compelling governmental interest. The other four male Catholic justices joined in this opinion.

- Justice Ginsburg dissented on the grounds that (1) having to pay for abortifacients does not affect the owners' exercise of their religion, and (2) commercial enterprises operating in corporate form do not have religious rights. Justice Sotomayor joined in the dissenting opinion, and Justices Breyer and Kagan joined as to the first ground but not the second.
- Query whether the division on the Court was one of Catholics vs. Jews, men vs. women, or justices nominated by Republican presidents vs. those nominated by Democratic presidents? The two racial minority justices split between the majority and the dissent. Where is a Protestant Justice when you really need one?

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

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

> Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?
>
> [A1]. Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee (which is $36,500 per year, per employee) under section 4980D of the Internal Revenue Code.

3. Guidance on the Affordable Care Act's employer shared responsibility payment. T.D. 9655, Shared Responsibility for Employers Regarding Health Coverage, 79 F.R. 8544 (2/12/14). Section 4980H was enacted by the Patient Protection and Affordable Care Act and amended by the Health Care and Education Reconciliation Act of 2010 and the Department of Defense and Full-Year Continuing Appropriations Act, 2011. Under § 4980H, an applicable large employer is subject to an assessable payment for a month if a full-time employee enrolls for that month through a health insurance exchange in a qualified health plan for which the employee receives a premium tax credit and the employer either fails to offer its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan or offers coverage that is not affordable or does not provide minimum value. The IRS and Treasury have promulgated Reg. §§ 54.4980H-0 through 54.4980H-6 providing comprehensive guidance regarding the § 4980H assessable payment, commonly known as the "employer shared responsibility payment." The regulations provide extensive guidance on determining an employer's status as an "applicable large employer," which is defined by statute as an employer that "employed an average of at least 50 full-time employees on business days during the preceding calendar year." The regulations generally are effective 2/12/14 and are applicable for periods after 12/31/14.

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

- *See also*, Fact Sheet on the final regulations implementing employer shared responsibility under the Affordable Care Act, released by the Treasury Department on 2/10/14, 2014 TNT 28-21.

4. **Providers of minimum essential health coverage and employers subject to the Affordable Care Act's shared responsibility payment must submit information returns for 2015 and are encouraged to submit returns for 2014.** T.D. 9660, Information Reporting of Minimum Essential Coverage, 79 F.R. 13220 (3/10/14); T.D. 9661, Information Reporting by Applicable Large Employers on Health Insurance Coverage Offered Under Employer-Sponsored Plans, 79 F.R. 13231 (3/10/14). Sections 6055 and 6056 were added to the Code by the Patient Protection and Affordable Care Act. Section 6055 requires annual information reporting by health insurance issuers, self-insuring employers, government agencies, and other providers of health coverage and requires the provider to furnish a related statement to each individual whose information is reported. Section 6056 requires annual information reporting by applicable large employers relating to the health insurance that the employer offers (or does not offer) to its full-time employees and requires the employer to furnish related statements to employees that employees may use to determine whether, for each month of the calendar year, they may claim on their individual tax returns a premium tax credit under § 36B. The IRS and Treasury have issued final regulations implementing these reporting requirements. The required statements generally must be furnished to individuals or employees for a calendar year on or before January 31 of the succeeding year, and the information returns for a calendar year generally must be filed on or before February 28 of the succeeding year (March 31 if filed electronically). The regulations generally apply for calendar years beginning after 12/31/14.

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

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

- *See also*, Fact Sheet on the final regulations implementing information reporting for employers and insurers under the Affordable Care Act, released by the Treasury Department on 3/5/14, 2014 TNT 44-30.

5. **Although married taxpayers must file a joint return to be eligible for the § 36B premium tax credit, married taxpayers who cannot file a joint return because they are victims of domestic abuse can still be eligible for the credit.** Notice 2014-23, 2014-16 I.R.B. 942 (3/26/14). Beginning in 2014, individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through an Affordable Insurance Exchange are allowed a premium tax credit under § 36B. One eligibility requirement is that individuals must file a joint return if married within the meaning of § 7703. See I.R.C. § 36B(c)(1)(C). Married individuals who live apart can be treated as not married if they meet the requirements of § 7703(b), but victims of domestic abuse might not meet those requirements. Accordingly, absent relief, victims of domestic abuse who are married and do not file a joint return for reasons related to the abuse (e.g., risk of injury arising from contacting the other spouse or a restraining order that prohibits contact with the other spouse) would be precluded from claiming the premium tax credit. The preamble to the final regulations issued under § 36B (T.D. 9590, 77 Fed. Reg. 30377 (5/23/12)) provided that Treasury and the IRS would propose

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

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

7. Thousands of dollars of tax breaks for buying luxury cars, pennies for taking the bus. TIPA retroactively extended through 12/31/14 the one year parity provision requiring that the monthly dollar limitation for transit passes and transportation in a commuter highway vehicle under § 132(f)(2) be applied as if it were the same as the dollar limitation for that month for employer-provided parking. Thus, for 2014, it increases the monthly exclusion for employer-provided transit and van-pool benefits to $250—the amount of the maximum exclusion for employer-provided parking benefits.

B. Qualified Deferred Compensation Plans

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

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

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

4. A payment from a qualified plan for an accident or health insurance premium generally constitutes a distribution under § 402(a) that is taxable to the distributee under § 72. T.D. 9665, Tax Treatment of Qualified Retirement Plan Payment of Accident or Health Insurance Premiums, 79 F.R. 26838 (5/12/14). These final regulations under § 402(a) clarify the rules on the tax treatment of payments by qualified retirement plans for accident or health insurance, explaining that generally amounts held in a qualified plan that are used to pay accident or health insurance premiums are taxable distributions under § 72 in the taxable year in which the premium is paid. They are effective on 5/12/14, and generally apply for taxable years that begin on or after 1/1/15, but retroactive applicability is available at taxpayer's election.

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

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

6. Some inflation adjusted numbers for 2015. I.R. 2014-99 (10/23/14).

- Elective deferral in §§ 401(k), 403(b), and 457 plans, increases (from $17,500) to $18,000 with a catch up provision for employees aged 50 or older of $6,000 (increased from $5,500).
- The limit on contributions to an IRA will be unchanged at $5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $61,000-$71,000 for single filers and heads of household, to $98,000-$118,000 for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and to $183,000-$193,000 for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $183,000-$193,000 for married couples filing jointly, and to $116,000-$131,000 for singles and heads of household.
- The annual benefit from a defined benefit plan under § 415 is unchanged at $210,000.
- The limit for defined contribution plans is increased (from $52,000) to $53,000.
- The amount of compensation that may be taken into account for various plans is increased (from $260,000) to $265,000, and increased (from $385,000) to $395,000 for government plans.
- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $61,000 for married couples filing jointly, to $45,750 for heads of household, and to $30,500 for singles and married individuals filing separately.

7. A case involving revocation of a retirement plan's qualification is different than a case involving the continuing qualification of a retirement plan. Go figure! RSW Enterprises, Inc. v. Commissioner, 143 T.C. No. 21(11/26/14). The petitioning corporations had established retirement plans and received a favorable determination letter from the IRS that the plans were qualified under § 401(a). The IRS later revoked the plans' qualified status on the grounds that (1) each plan failed to satisfy the coverage requirements of §§ 401(a)(3) and 410(b) and (2) failed to satisfy the § 401(a)(26) minimum participation requirements. The corporations petitioned the Tax Court under § 7476(a) for declaratory judgments that the plans' qualified status should not have been revoked. The IRS moved for summary judgment, which the Tax Court (Judge Buch) denied because there were material factual issues in dispute. He held that the Tax Court is not limited to considering solely the administrative record in a proceeding regarding revocation of qualified plan status where the parties disagree as to whether the administrative record contains all the relevant facts and as to whether those facts are in dispute. He rejected the IRS's argument that review was limited to the administrative record under *Stepnowski v. Commissioner*, 124 T.C. 198 (2005), *aff'd*, 456 F.3d 320 (3d Cir. 2006), which held that "[t]he legislative history of section 7476 makes clear that Congress did not expect the Court to conduct a trial de novo in declaratory judgment actions arising under that section, no matter whether that action arose with respect to the initial qualification or the continuing qualification of a retirement plan. ... Therefore, discovery or introduction of extrinsic evidence in such cases is inconsistent with the legislative intent that such cases be resolved without a trial based solely on the materials contained in the administrative record." Rather, under Tax Court Rule 217(a), "[i]n cases involving a revocation, we are limited to the administrative record 'only where the parties agree that such record contains all the relevant facts and that such facts are not in dispute.'" *Stepnowski* did not involve a revocation.

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

1. A requirement to sell employer stock back at a discount if the employee is sacked for "[f]ailure or refusal by Employee ... to cure by faithfully and diligently performing the usual and customary duties of his employment" is a substantial risk of forfeiture. Austin v. Commissioner, 141 T.C. No. 18 (12/16/13). The taxpayers received stock in a corporation in a § 351 transaction and entered into employment agreement and restricted stock agreements with the newly formed corporation. The taxpayers received 95 percent of the stock of the corporation and an ESOP acquired 5 percent of the stock for a promissory note. (The transactions occurred before the enactment of § 409(p) in 2004 and the tax years at issue were 2000-2003.) The taxpayers collectively were the entire board of directors of the corporation. The corporation made an S election. The employment agreements provided that upon termination of employment, they would receive less than the full fair market value of their S shares if they were terminated "for cause" during the initial term of the employment agreement; otherwise on termination of employment the taxpayers would receive in exchange for their stock 100 percent of the fair market value, determined by formula. The employment agreements defined termination "for cause" to include not only termination for "[d]ishonesty, fraud, embezzlement, alcohol or substance abuse," but also termination upon "[f]ailure or refusal by Employee ... to cure by faithfully and diligently performing the usual and customary duties of his employment." The stock certificates were legended as restricted stock. The taxpayers took the position that their stock was not fully vested and that pursuant to Reg. § 1.83-1(a)(1) they were not shareholders, with the result that all of the S corporation's income passed through to the ESOP and none passed through to them. The IRS asserted deficiencies based on the ground that the stock was not subject to forfeiture because Reg. § 1.83-3(c)(2) provides that a requirement that stock be forfeited "if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture." The IRS moved for summary judgment that the stock was not subject to a risk of forfeiture, but the Tax Court (Judge Lauber) denied the IRS's motion. The court held that the restricted stock agreement and employment agreement together constituted "an earnout restriction that *may* give rise to a 'substantial risk of forfeiture.'" (Emphasis added). Although the contractual provision addressed termination "for cause," "termination upon '[f]ailure or refusal by Employee ... to cure by faithfully and diligently performing the usual and customary duties of his employment' falls outside the scope of discharge 'for cause or for committing a crime' within the meaning of [Reg. § 1.83-3(c)(2)]." Judge Lauber reasoned that "an employee's inability or disinclination to work for the agreed-upon term of his employment contract is not a 'remote' event that is unlikely to occur." Moreover, a finding that Reg. § 1.83-3(c)(2) "precludes an earnout restriction from creating a 'substantial risk of forfeiture' would make that subparagraph of the regulation inconsistent with the statute."

- The IRS's other arguments, including that the taxpayer's stock was "substantially vested" because as the sole directors of the corporation they could "remove at will any ownership restrictions to which their stock was subject, so that the forfeiture conditions were unlikely to be enforced," presented issues for trial.

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

- The preamble states:

> These regulations are intended to clarify the definition of a substantial risk of forfeiture and are consistent with the interpretation that the IRS historically has applied, and therefore from the perspective of Treasury and the IRS they do not constitute a narrowing of the requirements to establish a substantial risk of forfeiture. See *Robinson v. Commissioner*, 805 F.2d 38 (1st Cir. 1986).

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

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

D. Individual Retirement Accounts

1. Are non-spousal inherited IRAs exempt from claims of creditors in bankruptcy? This decision created a conflict among the circuits. In re Clark, 714 F.3d 559 (7th Cir. 4/23/13), *aff'd sub. nom. Clark v. Rameker*, 134 S. Ct. 2242 (6/12/14). In an opinion by Judge Easterbrook, the Seventh Circuit held that an IRA inherited from someone other than the recipient's spouse is not exempt from claims of creditors in bankruptcy. The debtors were a married couple. The wife, Heidi Heffron-Clark, was named as beneficiary of her mother's IRA and, following her mother's death, transferred the funds to a Beneficiary Individual Retirement Account, commonly known as an inherited IRA. The debtors subsequently filed a chapter 7 bankruptcy petition and claimed an exemption for the funds in the inherited IRA under 11 U.S.C. § 522(b)(3)(C), which exempts from the claims of creditors "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under" certain Code sections, including § 408. (A similar exemption with identical language is found in 11 U.S.C. § 522(d)(12).) Judge Easterbrook reasoned that the funds in an inherited IRA are not "retirement funds" within the meaning of the statute: "an inherited IRA is a time-limited tax-deferral vehicle, but not a place to hold wealth for use after the new owner's retirement." He drew an analogy to the Bankruptcy Code's homestead exemption. A person who inherits a parent's home and rents it out, he reasoned, could not claim that the home is exempt from the claims of creditors because it used to be their parent's home. The Seventh Circuit's decision conflicts with several Bankruptcy Court and District Court decisions, as well as the Fifth Circuit's decision in ***In re Chilton***, 674 F3d. 486 (5th Cir. 3/3/12).

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

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

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

This statement appears to be contradicted in 4-522 COLLIER ON BANKRUPTCY ¶ 522.09 (Sixteenth Edition, on-line Lexis) (Categories of Exempt Property – Federal Exemptions; § 522(d)), which reads:

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

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

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

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

2. Honey, I shrunk the IRAs! Divorce is bad enough without learning that your IRAs have been depleted through forged withdrawals and that the IRS is asserting a deficiency. Roberts v. Commissioner, 141 T.C. No. 19 (12/30/13). The taxpayer and his wife permanently separated in January 2009 and were later divorced. The taxpayer maintained two IRAs. During 2008, a total of approximately $37,000 was distributed from the IRAs. The distributions were made pursuant to forged withdrawal requests and the checks representing those distributions were endorsed with forged signatures and deposited in a checking account that the taxpayer owned jointly with his wife, but which was used exclusively by his wife. The taxpayer did not know about or authorize the IRA withdrawals at the time they occurred and first learned of them in 2009, when he received Forms 1099-R. The Tax Court (Judge Marvel), considering an issue of first impression, held that the distributions were not includible in the taxpayer's gross income under § 408(d)(1), which provides that the "payee or distributee" must include in gross income in the manner provided under § 72 any amount paid or distributed out of an individual retirement plan. The court rejected the government's argument that the taxpayer was a payee or distributee under *Bunney v. Commissioner*, 114 T.C. 259 (2000), in which the court held that the payee or distributee of an IRA distribution generally is "the participant or beneficiary who, under the plan, is entitled to receive the distribution." The court reasoned that the taxpayer was not a payee or distributee within the meaning of § 408(d)(1) because "he did not request, receive, or benefit from the IRA distributions." (The court found that the taxpayer's wife received and spent the funds.) The court also rejected the government's argument that the taxpayer was a payee or distributee because the taxpayer ratified or acquiesced in the IRA withdrawals by: (1) failing to report the forged signatures to the financial institutions in a timely manner or make a claim based on those signatures, and (2) benefitting from the withdrawals in the divorce proceedings, in which the division of assets took into account that the funds went to the taxpayer's wife. Any ratification or acquiescence, the court reasoned, did not take place until 2009 at the earliest, and therefore could not affect whether the taxpayer was a payee or distributee in 2008, the year for which the deficiency was determined. Because the taxpayer was not subject to tax on the distributions, he also was not subject to the 10 percent penalty tax imposed on early withdrawals by § 72(t). The court imposed the § 6662(a) accuracy-related penalty based on the taxpayer's failure to report interest income unrelated to the IRAs, his underreporting of wage income, and his filing of a return for 2008 as a single taxpayer despite the fact that he was married. The 2008 return, which the taxpayer never saw, was prepared and filed by his wife.

3. The "one rollover per year rule" of § 408(d)(3)(B) applies to all of a taxpayer's IRAs, not to each one separately. Bobrow v. Commissioner, T.C. Memo. 2014-21 (1/28/14). The taxpayers, a married couple, maintained more than one IRA. During 2008, the husband, a tax attorney, withdrew $65,064 from his traditional IRA on April 14 and withdrew the same amount from his rollover IRA on June 6. He deposited $65,064 in his traditional IRA on June 10 and deposited the same amount in his rollover IRA on August 4. The taxpayers took the position that they were eligible to exclude both distributions from gross income under the 60-day rollover rule of § 408(d)(3)(A) because the "one rollover per year" rule of § 408(d)(3)(B) applies separately to each IRA maintained by a taxpayer. The Tax Court (Judge Nega) held that the once-per-year limitation of § 408(d)(3)(B) "is not specific to any single IRA maintained by an individual but instead applies to all IRAs maintained by a taxpayer." In doing so, the court relied on the plain language of § 408(d)(3)(B) and its prior holdings in *Martin v. Commissioner*, T.C. Memo. 1992-331 (6/8/92), *aff'd*, 987 F.2d 770 (5th Cir. 1993) and *Martin v. Commissioner*, T.C. Memo. 1994-213 (5/12/94). Thus, according to the court, a taxpayer who maintains multiple IRAs cannot make a tax-free rollover from each IRA within the one-year period. As a result, the court concluded that the husband's June 6 withdrawal from his rollover IRA was includible in gross income because, during the one-year period ending on that date, he had made a tax-free rollover of funds (the April 14 withdrawal) from his traditional IRA. The court also concluded that a withdrawal from the wife's traditional IRA was taxable and subject to the 10 percent penalty tax of § 72(t) because the funds were rolled over one day outside the 60-day limitation period and the wife was under age 59½.

- The court upheld a 20 percent § 6662(a) accuracy-related penalty for substantial understatement of income tax. In doing so, the court stated "Petitioners cite no authority supporting their position that the section 408(d)(3)(B) limitation applies separately to each IRA maintained by a taxpayer and not, as respondent argues and we agree, that the limitation applies across all IRAs maintained by a taxpayer." The court never discusses or cites Prop. Reg. § 1.408-4(b)(4)(ii) or IRS Publication 590, Individual Retirement Arrangements (IRAs), both of which provide that the one-rollover-per-year rule applies separately to each IRA that a taxpayer maintains.

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

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

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

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

d. **Don't roll me over (except sometimes).** Announcement 2014-32, 2014-48 I.R.B. 907_ (11/10/14). The IRS will apply the *Bobrow* interpretation of § 408(d)(3)(B) for distributions that occur on or after January 1, 2015. Thus an individual receiving an IRA distribution on or after January 1, 2015, cannot roll over any portion of the distribution into an IRA if the individual has received a distribution from any IRA in the preceding one-year period that was rolled over into an IRA. Under a transition rule, for distributions in 2015 a distribution occurring in 2014 that was rolled over is disregarded for purposes of determining whether a 2015 distribution can be rolled over under § 408(d)(3)(A)(i), provided that the 2015 distribution is from a different IRA that neither made nor received the 2014 distribution. The *Bobrow* aggregation rule, which takes into account all distributions and rollovers among an individual's IRAs, will apply to distributions from different IRAs only if each of the distributions occurs after 2014.

- A rollover from a traditional IRA to a Roth IRA is not subject to the one-rollover-per-year limitation, and such a rollover is disregarded in applying the one-rollover-per-year limitation to other rollovers. However, a rollover between an individual's Roth IRAs would preclude a separate rollover within the 1-year period between the individual's traditional IRAs, and vice versa.

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

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

5. **The Eighth Circuit, "appalled" at the unfairness of the government's position and characterizing a government argument as "downright silly," finds a valid partial rollover of IRA funds.** Haury v. Commissioner, 751 F.3d 867 (8th Cir. 5/12/14). During 2007, the taxpayer made several withdrawals from his IRA in order to make loans to two corporations in which he held stock. The taxpayer served as a board member and senior officer of each corporation and licensed to them certain technology he had developed. The taxpayer withdrew a total of $434,964.38 from his IRA during 2007 by making five separate withdrawals, including a withdrawal of $120,000 on February 15. The taxpayer also deposited $120,000 in his IRA on April 30. The Eighth Circuit, in an opinion by Judge Loken, reversed the Tax Court (Judge Foley) and concluded that the taxable IRA distributions were not $434,964.38, but rather that amount reduced by the $120,000 the taxpayer deposited on April 30. The Eighth Circuit reasoned that the Tax Court incorrectly concluded that the $120,000 deposit was a payment into the IRA that occurred more than sixty days after the $120,000 withdrawal on February 15. The taxpayer made a subsequent withdrawal of $168,000 on April 9, and the $120,000 deposit on April 30 qualified under § 408(d)(3)(D) as a partial rollover of the subsequently withdrawn

funds. Judge Loken stated that the court was "appalled at the unfairness of" the government's contention that the taxpayer, who had proceeded pro se in the Tax Court, had waived the partial rollover argument by not raising it below. Judge Loken also found "downright silly" the government's argument that the taxpayer had failed to prove that he had not made another tax-free rollover within the one-year period ending on April 30 because the government had access to all of the taxpayer's IRA transactions during that period and had failed to identify a disqualifying prior rollover.

6. Another sad self-directed IRA story. Dabney v. Commissioner, T.C. Memo. 2014-108 (6/5/14). The taxpayer wanted to purchase real property in his self-directed IRA at Charles Schwab, but the trustee would not execute the transaction. To complete the transaction, he directed the trustee to pay the purchase price out of the IRA and directed the title company handling the transaction to title the property in the name of "Guy M. Dabney Charles Schwab & Co. Inc Cust. IRA Contributory." Through a bookkeeping error, the property was titled in the taxpayer's name. Two years later he sold the property at a profit and the sales proceeds were wired directly into his Charles Schwab IRA. He treated the deposit as a rollover contribution, and Charles Schwab accepted the deposit as such. Contemporaneously with the sale, the taxpayer discovered that the property was incorrectly titled in his own name, and he promptly sought and received a scrivener's affidavit from the title company in which it admitted fault for the error. The Tax Court (Judge Vasquez) upheld the IRS's determination that the 2009 distribution was a taxable (premature, because the taxpayer was not 59½) withdrawal. The taxpayer could not be treated as purchasing the property on behalf of the IRA because Charles Schwab did not permit its IRAs to hold real property. The withdrawal also was not a trustee-to-trustee transfer and was not rolled-over within 60 days. "The flaw was not in Mr. Dabney's intent but in his execution. Had Mr. Dabney initiated a rollover or a trustee-to-trustee transfer of funds from his Charles Schwab IRA to a different IRA—one permitted to purchase and hold real property—he would have achieved his goal without any unintended tax consequences." The court declined to impose accuracy-related penalties.

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

8. "♫♪Roll me over … And do it again. ♫♪" Or not! Bohner v. Commissioner, 143 T.C. No. 11 (9/23/14). The taxpayer, a retired federal employee who participated in the Civil Service Retirement System (CSRS), was informed by the CSRS that he could increase his CSRS retirement annuity by paying an additional amount into the CSRS. He paid the amount on April 27, 2010. To make this contribution he withdrew funds from his bank account and borrowed additional funds. He repaid the loan and restored the balance of his bank account by making withdrawals from his traditional IRA. He received a distribution of $5,000 on April 15, 2010 and a distribution of $12,832 on May 3, 2010. The taxpayer did not report any of the amounts he withdrew from his IRA as taxable income, taking the position that he engaged in a tax-free rollover under § 408(d)(3). The IRS argued that rollover contributions cannot be made to the CSRS. The Tax Court, in a reviewed opinion (8-1-6) by Judge Kerrigan, held that because the CSRS did not accept the taxpayer's remittance as a rollover, he was required to include his withdrawals in gross income. The linchpin of the majority's reasoning appeared to be that "The statutory provisions governing CSRS do not include a provision allowing pretax employee contributions."

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

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

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. 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? Massachusetts v. United States Department 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 of 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*, 133 S. Ct. 786 (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.

b. Same-sex spouses in valid marriages now get to share in marriage penalties and marriage bonuses when filing income tax returns because "the principal purpose and the necessary effect of [DOMA] are to demean those persons who are in a lawful same-sex marriage." United States v. Windsor, 133 S. Ct. 2675 (6/26/13). The Defense of Marriage Act (DOMA), Pub. L. No. 104–199, 110 Stat. 2419 (1996), defines "marriage" in any act of Congress, which (of course) includes the Code, as a legal union "between one man and one woman" as husband and wife. DOMA also defines the word "spouse" to mean only a person of the "opposite sex" who is a husband or wife. This case involved whether the § 2056 estate tax marital deduction was allowable with respect to a bequest to a same-sex spouse whose marriage to the decedent was recognized under local law. The Supreme Court held that § 3 of DOMA — the provision that limits the meaning of the word "marriage" to "a legal union between one man and one woman as husband and wife," and provides that "the word 'spouse' refers only to a person of the opposite sex who is a husband or wife" — is an unconstitutional denial of equal protection in violation of the Due Process Clause of the Fifth Amendment. As a result, the § 2056 estate tax marital deduction was allowable. It follows that for income tax purposes same-sex married couples whose marriages are recognized by local law are eligible to file a joint return and if they do not file a joint return must file as married filing separately.

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

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

c. Shakespeare called it "The Merry Wives of Windsor." And the IRS interprets *Windsor* broadly – a same-sex marriage celebrated under the laws of one state is a federal tax "marriage" in every state. Rev. Rul. 2013-17, 2013-38 I.R.B. 201 (8/29/13). In the wake of *United States v. Windsor*, 133 S. Ct. 2675 (2013), the IRS ruled that the marital status of individuals of the same-sex who are lawfully married under the laws of a state that recognizes such marriages will be recognized for all purposes. The ruling held that for Federal tax purposes (1) the terms "spouse," "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex; and (2) a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex will be recognized even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. However the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term "marriage" does not include such formal relationships.

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

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

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

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

g. Section 401(k) and 401(m) safe harbor plans can make mid-year amendments pursuant to Notice 2014-19 to reflect *Windsor* and Rev. Rul. 2013-17. Notice 2014-37, 2014-24 I.R.B. 1100 (5/15/14). This notice resolves uncertainty concerning whether mid-year plan amendments are permitted to § 401(k) and § 401(m) safe harbor plans by specifying that sponsors of such plans can adopt mid-year amendments pursuant to Notice 2014-19 to reflect the decision in *United States v. Windsor*, 570 U.S. ___, 133 S. Ct. 2675 (2013), and the holdings of Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

2. And the IRS starts administering national health care. T.D. 9632, Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage, 78 F.R. 53646 (8/30/13). The IRS and Treasury have promulgated Reg. §§ 1.5000A-0 through 1.5000A-5 providing comprehensive guidance regarding the requirement to maintain minimum essential coverage under § 5000A, which was enacted by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, as amended by the TRICARE Affirmation Act and Public Law 111–173. The regulations provide guidance to individual taxpayers on their liability under § 5000A for the shared responsibility payment for not maintaining minimum essential coverage. The T.D. largely finalizes the rules in REG–148500–12, 78 F.R. 7314 (2/1/13). The regulations are effective on 8/30/13.

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

b. Final regulations provide guidance on issues related to the Affordable Care Act's individual mandate. T.D. 9705, Minimum Essential Coverage and Other Rules Regarding the Shared Responsibility Payment for Individuals, 79 F.R. 70464 (11/26/14). The Treasury and IRS have finalized proposed regulations that provide guidance on issues related to the requirement of § 5000A that individuals maintain minimum essential coverage (REG-141036-13, Minimum Essential Coverage and Other Rules Regarding the Shared Responsibility Payment for Individuals, 79 F.R. 43021 (1/27/14)). Under § 5000A, individuals who do not maintain minimum essential coverage and do not qualify for an exemption are subject to a penalty beginning in 2014. The Treasury Department and the IRS previously issued final regulations that (1) provide that coverage under the Medicaid program is minimum essential coverage except for certain Medicaid coverage that may provide limited benefits, and (2) state in the preamble that future regulations may identify other government-sponsored programs that are not minimum essential coverage. T.D. 9632, Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage, 78 F.R. 53646 (8/30/13).

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

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

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

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

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

B. Miscellaneous Income

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

- Stay tuned. This certainly isn't the end of the story. The Seventh Circuit reversed another of Judge Crabb's off-the-wall decisions in favor of the same plaintiff several years ago.

a. The Seventh Circuit reverses without reaching the merits of the constitutional issue. Freedom From Religion Foundation, Inc. v. Lew, 114 A.F.T.R.2d 2014-6570 (7th Cir. 11/13/14). In an opinion by Judge Flaum, the Seventh Circuit reversed and vacated the District Court's judgment on the basis that the plaintiffs lacked standing to challenge § 107(a)(2). "A person suffers no judicially cognizable injury merely because others receive a tax benefit that is conditioned on allegedly unconstitutional criteria, even if that person is otherwise 'similarly situated' to those who do receive the benefit. Only a person that has been denied such a benefit can be deemed to have suffered a cognizable injury. The plaintiffs here have never been denied the parsonage exemption because they have never requested it; therefore, they have suffered no injury."

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

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

4. Airline tickets from your bank are treated just like toasters were treated in the good old days. Shankar v. Commissioner, 143 T.C. No. 5 (8/26/14). The taxpayer banked at Citibank, which reported on a 2009 Form 1099-MISC, Miscellaneous Income, "Other income" of $668, which resulted from him redeeming 50,000 "thank you points," issued to him by Citibank by virtue of the customer relationship, to purchase an airline ticket for travel. The taxpayer did not report the income, and the IRS asserted a deficiency. (For the bigger dollar issue in the case, which got the case to the Tax Court, see Part IV.D.) At trial, the IRS introduced evidence showing that the Form 1099-MISC properly and accurately reported the income shown thereon. The Tax Court (Judge Halpern) upheld the deficiency. "[T]he omitted income was a noncash award for opening a bank account. ... [It was] a premium for making a deposit into, or maintaining a balance in, a bank account. In other words, something given in exchange for the use (deposit) of Mr. Shankar's money; i.e., something in the nature of interest." As such, it was includable in gross income.

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

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

> Consistent with prior practice, the IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel. Any future guidance on the taxability of these benefits will be applied prospectively.
>
> This relief does not apply to travel or other promotional benefits that are converted to cash, to compensation that is paid in the form of travel or other promotional benefits, or in other circumstances where these benefits are used for tax avoidance purposes.

5. When disappointed tax shelter investors win big against their incompetent tax advisors, they also win against the IRS. Cosentino v. Commissioner, T.C. Memo. 2014-186 (9/11/14). The taxpayers invested in a tax shelter scheme to shelter gains on the sale of real estate, and filed tax returns claiming the losses purportedly generated by the tax shelter scheme. After they discovered that the tax shelter scheme was an abusive tax shelter, they filed amended returns and paid a deficiency, interest, and penalties. Subsequently, the taxpayers recovered $375,000 in settlement of a suit against their tax advisors that alleged the advisors were negligent and breached their fiduciary duties to the taxpayers by advising them to use what after the fact was discovered was an abusive tax shelter. The complaint alleged damages totaling $640,749.80: (1) advisor fees of $45,000; (2) costs and losses incurred in connection with executing the transaction of $9,151; (3) federal and state income taxes paid (including lost opportunity to use legitimate tax deferral methods under § 1031) in the total amount of $456,930; (4) interest paid to the IRS of $18,783.59; (5) penalties payable to the IRS of $89,925; (6) interest payable to the State of Oregon of $12,666.21; (7) penalties payable to the State of Oregon of $8,294.00; plus (8) certain interest and penalties yet to be determined. The settlement agreement did not allocate the $375,000 among the various claimed losses. The taxpayers did not report the $375,000 as includable in gross income and the IRS asserted a deficiency. The Tax Court (Judge Chiechi) held that under the principles of *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *Concord Instruments Corp. v. Commissioner*, T.C. Memo. 1994-248, and Rev. Rul. 57-47, 1957-1 C.B. 23, the recovery was a recovery of capital that was not includable in gross income except for amounts received for (1) damages claimed in the complaint for which they were compensated but for which they had claimed deductions that had been allowed and (2) certain damages that they claimed in the complaint and for which they were compensated but which they in fact did not incur or incurred in amounts that were less than the amounts of those damages that they alleged in the complaint. The court went on to allocate the $375,000 ratably among the various types of damages alleged in the complaint. Accordingly, the following amounts were includable: (1) amounts allocable to costs and losses incurred in connection with executing the transaction, which had been allowed as a deduction; (2) amounts allocable to Oregon income taxes, for which a deduction had been allowed; (3) amounts allocable to federal tax penalties claimed in the complaint to have been paid that were conceded to have exceeded the penalties actually ultimately paid, and (4) amounts allocable to Oregon tax penalties claimed in the complaint to have been paid that ultimately had been waived. The actual amounts were subject to a rule 155 computation.

6. The Tax Court reasons that there can't be COD income without a prior tax benefit. Mylander v. Commissioner, T.C. Memo. 2014-191 (9/17/14). The Tax Court

(Judge Vasquez) held that the taxpayer did not recognize COD income when he was released from a guarantee on which the principal obligor had defaulted. The facts were convoluted, but the reasoning is clear and is important.

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

(Emphasis added).

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

7. Hallelujah! The government finally recognizes that nonpayment of a debt still owed is not necessarily COD income. REG-136676-13, Removal of the 36-Month Non-Payment Testing Period Rule, 79 F.R. 61791 (10/15/14). The IRS and Treasury have published proposed amendments to Reg. § 1.6060P-1 that would eliminate the rule that a deemed discharge of indebtedness for which a Form 1099-C, "Cancellation of Debt," must be filed occurs at the expiration of a 36-month non-payment testing period. According to the Preamble: "[I]nformation reporting under section 6050P should generally coincide with the actual discharge of a debt. Because reporting under the 36-month rule may not reflect a discharge of indebtedness, a debtor may conclude that the debtor has taxable income even though the creditor has not discharged the debt and continues to pursue collection."

8. This may be one of the only sensible extenders. TIPA retroactively extended through 12/31/14 the § 108(a)(1)(E) exclusion for up to $2 million ($1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness.

9. Compassionate saving. New code § 529A, enacted by the Achieving a Better Life Experience (ABLE) Act of 2014, provides yet another tax-favored savings account—the ABLE account. Like 529 accounts (used to save for college education), ABLE accounts must be established by a state. Only beneficiaries who became disabled before reaching age 26 are eligible. An eligible individual is an individual (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to benefits based on blindness or disability under the Social Security Disability Insurance program or the SSI program. A disability certification is a certification to the satisfaction of the IRS made by the eligible individual or the parent or guardian of the eligible individual, that the individual meets the requirements relating to disability or blindness that includes a copy of the individual's diagnosis relating to the individual's relevant impairment or impairments, signed by a licensed physician. For the most part, ABLE accounts are limited to beneficiaries who are blind or have developmental disabilities, mental illness, and severe childhood conditions such as cerebral palsy. The maximum contribution is $14,000 per year (adjusted for inflation after 2015) in cash, but states could impose maximum limits on total contributions. A beneficiary may have only one account. Contributions are not deductible, but the income in the account is accumulated tax-free. A contribution to an ABLE account is treated as a completed gift of a present interest to the beneficiary of the account. Thus, the contribution qualifies for the per-donee annual gift tax exclusion ($14,000 for 2014) and, to the extent of the exclusion, is exempt from the generation skipping transfer tax. Withdrawals are tax-free to the extent used for eligible services, including education; housing; transportation; employment support; health, prevention, and wellness costs; assistive technology and personal support services; and other IRS-approved expenses. Distributions used for nonqualified expenses are includable in income to the extent they represent a distribution of earnings (generally determined in the manner provided for annuities in § 72) and subject to a 10 percent penalty. (A distribution from an ABLE account generally is not subject to gift tax or GST tax.) ABLE accounts can generally be rolled over only into another ABLE account for the same individual or into an ABLE account for a sibling who is also an eligible individual. Upon the death of the beneficiary the balance in the account (after Medicaid reimbursements) is distributable to the deceased beneficiary's estate or to a designated beneficiary; the distribution will be subject to income tax on investment earnings, but not to a penalty. Generally, account assets are not included in determining eligibility for SSI or Medicaid. However, SSI payments are suspended when an account balance exceeds $100,000, but Medicaid benefits would continue.

10. "We see no limit on the mischief that ruling in Perez's favor might cause: A professional boxer could argue that some part of the payments he received for his latest fight is excludable because they are payments for his bruises, cuts, and nosebleeds. A hockey player could argue that a portion of his million-dollar salary is allocable to the chipped teeth he invariably suffers during his career. And the same would go for the brain injuries suffered by football players ... ." Perez v. Commissioner, 144 T.C. No. 4 (1/22/15). The taxpayer was a human egg "donor," who underwent surgery to remove her eggs and pursuant to a contract received a $10,000 payment "for Donor's time, effort, inconvenience, pain, and suffering in donating her eggs." The Tax Court (Judge Holmes) held that the payment was includable in income as compensation for services and not excluded as "damages" under § 104(a)(2). The 2012 amendments to Reg. § 1.104-1(c) that removed the requirement that to be excludable under § 104(a)(2) damages must have been "based upon tort or tort type rights" was not intended to extend the exclusion to instances where there was no law suit or threat of a law suit and the definition in Reg. § 1.104-1(c)(1) of "damages" as "an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution" was valid. The 2012 amendment "reflected a profusion of remedies for persons who are physically injured and recover under no-fault statutes, so that they are treated like those who are physically injured and recover through more traditional actions in tort. But that regulation still addresses situations where a taxpayer settles a claim for physical injuries or physical sickness before—or at least in lieu of—seeing litigation through to its conclusion."

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

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

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

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

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

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

> A owns a lakeside cottage which A rents during the summer. A and B, A's spouse, arrive late Thursday evening after a long drive to prepare the cottage for the rental season. A and B prepare dinner but do no work on the unit that evening. A spends a normal work day working on the unit Friday and Saturday; B helps for a few hours each day but spends most of the time relaxing. By Saturday evening, the necessary maintenance work is complete. Neither A nor B works on the unit on Sunday; they depart shortly before noon. The principal purpose of the use of the unit from Thursday evening through Sunday morning is to perform maintenance work on the unit. Consequently, the use during this period will not be considered personal use by A.

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

D. Deductions and Credits for Personal Expenses

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

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

2. The IRS finally gets it *Knight*.[8] T.D. 9664, Section 67 Limitations on Estates or Trusts, 79 F.R. 26616 (5/9/14). The Treasury and IRS have finalized proposed regulations under § 67 (REG-128224-06, Section 67 Limitations on Estates or Trusts, 76 F.R. 55322 (9/7/11)). Reg. § 1.67-4 provides comprehensive rules dealing with the application of the § 67(e) 2-percent floor to administration expenses incurred by estates and non-grantor trusts. In applying the 2-percent floor, the determinative factor is whether the expense "commonly or customarily would be incurred by a hypothetical individual owning the same property," focusing on "the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service." Fees for investment advice are covered by the 2-percent floor, but incremental costs of investment advice incurred because the advice is rendered to a trust or estate are not subject to the floor. Bundled fees, i.e., a single stated fee covering all services, can be allocated by "[a]ny reasonable method."

3. The premium tax credit and federally facilitated exchanges:

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

> (2) Premium assistance amount. — The premium assistance amount determined under this subsection with respect to any coverage month is the amount equal to the lesser of—
>
> (A) the monthly premiums for such month for 1 or more qualified health plans offered in the individual market within a State which cover the taxpayer, the taxpayer's spouse, or any dependent (as defined in section 152) of the taxpayer *and which were enrolled in through an Exchange established by the State* under 13111 of the Patient Protection and Affordable Care Act …

[8] *Knight v. Commissioner*, 552 U.S. 181 (2008), held that § 67 can apply to limit the deduction by a trust of investment advisor's fees. The clause of § 67(e)(1), excepting from the floor costs that would not have been incurred if the property were not held by a trust or estate, "excepts from the two-percent floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur." At the time the *Knight* case was decided, Prop. Reg. § 1.67-4 would have resolved the conflict in the case law that preceded the *Knight* decision by providing that only expenses incurred by estates or non-grantor trusts that are unique to an estate or trust are not subject to the § 67 two-percent floor. *Knight* expressly rejected the government's argument that § 67(e)(1) properly could be read to limit deductible trust administration expenses only to those "unique" to a trust.

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

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

- Judge Edwards vigorously dissented characterizing the plaintiff's action as a "not-so-veiled attempt to gut the Patient Protection and Affordable Care Act" and concluding that "[t]he majority opinion ignores the obvious ambiguity in the statute and claims to rest on plain meaning where there is none to be found." His opinion emphasized that "'[t]he plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole,'" quoting ***Robinson v. Shell Oil Co.***, 519 U.S. 337, 341 (1997). Applying this standard, considering the ACA as a whole, he applied a *Chevron*[10] analysis that found the language of § 36B(b)(2) to be ambiguous and the government's interpretation of the regulation to be permissible and reasonable.

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

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

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

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

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

c. The original Moops found friends in high places to peer all over the Moors. The Supreme Court granted a petition for a writ of certiorari to the Fourth

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

Circuit in ***King v. Burwell***, 759 F.3d 358 (4th Cir. 7/22/14), and will consider the issue later this Term. 135 S. Ct. 475 (11/7/14).

4. The IRS is undeterred by the *Halbig* decision. Revenue Procedure 2014-37, 2014-33 I.R.B. 363 (7/25/14). This revenue procedure provides indexing adjustments for certain provisions under §§ 36B and 5000A. It updates the Applicable Percentage Table in § 36B(b)(3)(A)(i), which is used to calculate an individual's premium tax credit for taxable years beginning after calendar year 2014. This revenue procedure also updates the required contribution percentage in § 36B(c)(2)(C)(i)(II), which is used to determine whether an individual is eligible for affordable employer-sponsored minimum essential coverage under § 36B for plan years beginning after calendar year 2014. Additionally, this revenue procedure cross-references the required contribution percentage under § 5000A(e)(1)(A) for plan years beginning after calendar year 2014, as determined under guidance issued by HHS. This percentage is used to determine whether an individual is eligible for an exemption from the individual shared responsibility payment because of a lack of affordable minimum essential coverage.

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

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

> The term "child with special needs" means any child if—
>
> (A) a State has determined that the child cannot or should not be returned to the home of his parents,
>
> (B) such State has *determined* that there exists with respect to the child a specific factor or condition (such as his ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions or physical, mental, or emotional handicaps) because of which it is reasonable to conclude that such child cannot be placed with adoptive parents without providing adoption assistance, and
>
> (C) such child is a citizen or resident of the United States (as defined in section 217(h)(3)).

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

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

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

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

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

- *Accord, Smoker v. Commissioner*, T.C. Memo. 2013-56.

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

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

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

E. Divorce Tax Issues

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

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

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

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

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

2. Does this case spell the death knell for state court orders conditioning the surrender of dependency exemptions on meeting child support obligations? Swint v. Commissioner, 142 T.C. 131 (2/24/14). The Tax Court (Judge Ruwe) held that an agreed-entry state court order awarding a noncustodial parent the dependency exemption on the condition that he was current with his child support obligations was insufficient to permit him to claim the dependency exemption (and child credit) in a year before Form 8332 was required. Although a court order or decree or a separation agreement entered prior to July 2, 2008, can be a written declaration if it satisfies certain requirements, the order in this case failed to meet those requirements. The plain language of § 152(e)(2)(A) provides that the noncustodial parent can claim the dependency exemption only if “the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year.” The taxpayer’s claim failed on two grounds: First, the custodial parent did not sign “a written declaration” because the agreed entry was not signed by her. Second, the language “will not claim” in § 152(e)(2)(A) is unconditional. “As a result, in order for a written declaration to comply with section 152(e)(2)(A) the declaration by the custodial parent that he or she ‘will not claim such child as a dependent’ must also be unconditional.” A conditional declaration cannot comply with § 152(e)(2)(A).

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. If the IRS continues to choose cases with bad facts to litigate the issue of whether it’s corporate or personal goodwill, the IRS’s batting average on this issue will start to look like the taxpayers’ batting average in tax shelter cases. Bross Trucking, Inc. v. Commissioner, T.C. Memo. 2014-107 (6/5/14). For many years Mr. Bross had owned and operated Bross Trucking, Inc., using leased vehicles. Bross Trucking's principal customers were three businesses owned by other Bross family members. Bross Trucking did not have any formal written service agreements with its customers, relying instead on Mr. Bross’s close personal relationships with the owners of the customer businesses. Due to violations of state regulatory law, Bross Trucking was in danger of losing its hauling authority. As a result, Bross’s sons—who were owners of Bross Trucking’s customers—formed a new trucking company, LWK Trucking, 98.2 percent of which was owned by Bross’s sons’ self-directed IRAs and the remainder of which was owned by an unrelated third party. Mr. Bross was not involved in managing LWK Trucking. LWK Trucking hired several Bross Trucking employees and leased trucks that formerly had been leased to Bross Trucking. Until the vehicles were repainted (or magnetic signs installed) they bore the Bross Trucking logo. The IRS asserted that Bross Trucking had distributed “its operations,” including “(1) goodwill; (2) established revenue stream; (3) developed customer base; (4) transparency of the continuing operations between the entities; (5) established workforce including independent contractors; and (6) continuing supplier relationships,” all of which the court collectively described as “goodwill” to Mr. Bross, triggering gain to the corporation (which did not liquidate until several years later) under § 311(b) and that Mr. Bross in turn had made a taxable gift of that goodwill to his sons. The Tax Court (Judge Paris), based on analogizing the facts in the instant case to the differences in the facts and results in *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998) and *Solomon v. Commissioner*, T.C. Memo. 2008-102, concluded that except for workforce in place Bross Trucking had no goodwill at the time of the “alleged transfer.” Although it “might have had elements of corporate goodwill at some point ... through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name.” Judge Paris went on to find that “The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry.”

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

Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill.

Furthermore, "Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement." No other Bross Trucking intangible assets were transferred because Bross Trucking's prior customers became LWK's customers and no longer wanted to deal with Bross Trucking due to its regulatory problems, and "LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company."

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

> Goodwill is often defined as the expectation of continued patronage by existing customers. *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 572-573, 113 S. Ct. 1670, 123 L. Ed. 2d 288 (1993). A key employee may personally create and own goodwill independent of the corporate employer by developing client relationships. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 207-208 (1998). The corporation may benefit from using the personally developed goodwill while the key employee works for the entity, but the corporation does not own the goodwill and therefore it is not considered a corporate asset. Id. at 208. The employee may, however, transfer any personal goodwill to the employer through a covenant not to compete or other agreement that transfers the relationships to the employer. See id. at 207; *H&M, Inc. v. Commissioner*, T.C. Memo. 2012-290. Absent such an agreement, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation.
>
> Kevin's goodwill was personally owned independent of STN.Com. STN.Com's success was heavily dependent on The Word because of their symbiotic relationship. To launch The Word, it was Kevin who contacted religious leaders in the Detroit area and Rev. Jackson in Chicago. Along with his notable contacts and his father, he went to Los Angeles to meet with DirecTV representatives about broadcasting The Word. His meeting was successful and it eventually led to the national broadcasting of The Word on cable television. Kevin was the face of the operation because he was the individual soliciting content and pursuing broadcast opportunities.
>
> Kevin's personal goodwill was further displayed when ministers chose to contribute to The Word after learning that The Word was a nonprofit organization. When contributing ministers asked about ownership opportunities, Kevin responded that The Word was a nonprofit organization and could not be sold. It appeared to the contributing ministers that there was not a corporation employing Kevin. The ministers conducted business with Kevin because they trusted him personally, not because he was a representative or employee of STN.Com. In other words, STN.Com could not own Kevin's goodwill because

the customers did not readily realize that Kevin actually worked for STN.Com. Thus, he cultivated personal goodwill with these professionals and he independently owned the asset of personal goodwill, not STN.Com.

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

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

C. Liquidations

D. S Corporations

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

a. And the taxpayers' invocation of a prayer to the god *Gitlitz* falls on deaf ears in the Third Circuit. Ball v. Commissioner, 742 F.3d 552 (3d Cir. 2/12/14). The Third Circuit (in an opinion by Judge Van Antwerpen) affirmed the Tax Court's decision. The court reasoned that gains that are not recognized by virtue of a specific Code provision are not items of gross income, citing Reg. § 1.61-6(b)(1), and § 332 specifically provides nonrecognition on the liquidation of a controlled subsidiary. Thus, making the QSub election did not give rise to an item of gross income. The court found *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), to be inapposite, because *Gitlitz* addressed payments that explicitly were included in gross income under § 61(a)(12) but excluded under § 108, but in the instant case § 332 worked to exclude the gain from being included in gross income under § 61(a)(3).

2. The Treasury Department finalizes major surgery on the rules for determining an S corporation shareholder's basis limitation for passed-through losses under § 1366(d). T.D. 9682**,** Basis of Indebtedness of S Corporations to Their Shareholders, 79 F.R. 42675 (7/23/14). The Treasury Department has finalized amendments to Reg. § 1.1366-2 proposed in REG-134042-07, Basis of Indebtedness of S Corporations to Their Shareholders, 77 F.R. 34884 (6/12/12), that deal with determination of an S corporation shareholder's basis in any debt of the S corporation, which principally affects the limitation on the pass-through of losses under § 1366(d). The amended regulations expressly provide that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg.

§ 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Reg. § 1.1366-2(a)(2)(i). Furthermore, Reg. § 1.1366-2(a)(2)(ii) expressly provides that:

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

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

- The preamble to the proposed regulations states that "[u]nder these proposed regulations, an incorporated pocketbook transaction [see, e.g., *Yates v. Commissioner*, T.C. Memo. 2001-280; *Culnen v. Commissioner*, T.C. Memo. 2000-139] increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation."
- Reg. § 1.1366-2(a)(2)(iii), Ex. (2) blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation "constitutes bona fide indebtedness" from the borrower S corporation to the shareholder. Example (3) in the regulation blesses a basis increase resulting from a distribution to a shareholder by one S corporation (S1) of a note evidencing the indebtedness of a second S corporation (S2) if after the distribution S2 is indebted to the shareholder and "the note constitutes bona fide indebtedness" from S2 to the shareholder where under local law the distribution relieved S2 of its obligation to S1 and S2 was liable only to the shareholder; however, whether S2 is indebted to the shareholder rather than S1 is determined under general federal tax principles and depends upon all of the facts and circumstances. Reg. § 1.1366-2(a)(2)(iii), Ex. (1) provides that a bona fide indebtedness from an S corporation to a disregarded entity (LLC) owned by the shareholder results in an increase in basis of indebtedness for the shareholder.
- The regulations do not attempt to clarify the meaning of "bona fide indebtedness," or provide any examples of relevant facts and circumstances, but rely on "general Federal tax principles." This 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 to the proposed regulations refers to *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998); *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); and *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973), as relevant authorities. In the preamble to the final regulations the Treasury department expressly declines to accept a commentator's suggestion that the final "regulations provid[e] that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness," but "[w]ith respect to guarantees, however, the final regulations retain the economic outlay standard."
- The amended regulations do not address how to determine the basis of the shareholder's stock in the S corporation. 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 to the proposed regulations, the Treasury Department and the IRS requested comments concerning the propriety of basis calculations in the S corporation and partnership context, similar to the one currently in Reg. § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital

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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 preamble to the final regulations states that "[t]he Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance."

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

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

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

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

E. Mergers, Acquisitions and Reorganizations

1. **The Ninth Circuit finds basis in rights created from the collapse of the savings and loan industry in the 1970s: the hell with § 362(b).** Washington Mutual, Inc. v. United States, 636 F.3d 1207 (9th Cir. 3/3/11). The taxpayer, as the successor corporation to Home Savings of America, filed a refund action claiming amortization deductions for certain rights, and loss deductions for abandonment of branching rights, created in a § 368(a)(1)(G) reorganization by the Federal Savings and Loan Insurance Corporation (FSLIC) in which Home Savings acquired three failed savings and loan associations. The District Court granted summary judgment to the IRS, concluding that Home Savings had no basis in the rights. The Ninth Circuit reversed and remanded, disagreeing with the District Court's conclusion regarding basis. As part of the acquisition of the three failed thrifts in a supervisory merger transaction structured as a type G reorganization, FSLIC entered into an "Assistance Agreement" with Home Savings that included, among other things, approval for Home Savings to establish branches in Florida and Missouri as if Home Savings maintained its home office in those states, and approval of the purchase method of accounting under which Home Savings was permitted to apply a percentage of acquired intangible assets in its deposit base and for amortization of the remainder over forty years. The Ninth Circuit accepted the taxpayer's argument and concluded that the excess of liabilities of the acquired thrifts over the value of assets represented a cost that was consideration for the rights represented in the Assistance Agreement in the integrated transaction, and concluded that allowing the taxpayer a cost basis was not inconsistent with characterizing the transaction as a § 368(a)(1)(G) reorganization, notwithstanding the transferred basis rule of § 362(b). The Court rejected the IRS's assertion that "recognizing Home Savings a cost basis in the Rights based on the assumption of FSLIC's liabilities requires characterizing some of the acquired thrifts' liabilities as FSLIC's liabilities, because Home Savings did not pay FSLIC or the Bank Board separate consideration for the Rights." The District Court concurred with the IRS position holding that the excess liabilities of the acquired thrifts were the same as FSLIC's insurance liabilities which remained liabilities of FSLIC. The Ninth Circuit reasoned that Home Savings received a generous incentive package, the cost of which was the excess of the failing thrifts' liabilities over the value of their assets. A concurring opinion argued that the acquired rights had a fair market value basis as acquired directly from FSLIC in exchange for taking over the liabilities of the failed thrifts. The Ninth Circuit remanded the case to the District Court to

determine the proper amortization amounts for the intangibles and the amount of abandonment loss for the branch rights.

a. On remand, the taxpayer fails to establish the amount of its cost basis for the intangibles and fails to demonstrate that it abandoned the branch rights. Washington Mutual, Inc. v. United States, 996 F. Supp. 2d 1095 (D. Wash. 2/10/14). On remand from the Ninth Circuit, the District Court determined that the taxpayer failed to establish its cost basis in the rights that it acquired through the incentive package it received from the FSLIC as part of the supervisory merger. For this reason, the court concluded, the taxpayer could not take amortization or loss deductions with respect to the rights. Under the approach dictated by the Ninth Circuit, the amount the taxpayer paid for the rights was equal to the excess of the failing thrifts' liabilities over the value of their assets. The taxpayer conceded that the total fair market value of the rights it received was greater than the amount the taxpayer paid for them. The District Court reasoned that, in order to allocate the purchase price among the rights the taxpayer received, the taxpayer had to establish the fair market value of *each* right the taxpayer received. The court concluded that the taxpayer failed to establish, to a reasonable degree of certainty, the value of one of the rights (the "Missouri Branching Right"), which gave the taxpayer the right to open branches in Missouri. The court agreed with the government that the discounted cash flow valuation model used by the taxpayer's expert was too flawed to form a reliable basis for valuing the Missouri Branching Right.

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

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

3. The IRS eliminates the elective location of E&P in tax-free reorganizations. T.D. 9700, 79 F.R. 66616 (11/10/14), Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another; Acquiring Corporation for Purposes of Section 381. The IRS and Treasury have finalized proposed amendments to Reg. § 1.381-1(a), REG-131239-13, Acquiring Corporation for Purposes of Section 381, 79 F.R. 26190 (5/7/14), and to Reg. § 1.312-11, REG-141268-11, Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another, 77 F.R. 22515 (4/16/12). As amended, Reg. § 1.381(a)-1(b)(2) provides that for purposes of determining the corporation that succeeds to the target corporation's tax attributes in a tax-free reorganization, the acquiring corporation is the corporation that, pursuant to the plan of reorganization, directly acquires the assets transferred by the transferor corporation, even if that corporation ultimately retains none of the assets so transferred. According to the Preamble to the proposed regulations: "The [prior] regulations under section 381 yield an identical result, except when a single controlled subsidiary of the direct transferee corporation acquires all of the assets transferred by the transferor corporation pursuant to a plan of reorganization. In that case, the [prior] regulations treat the subsidiary as the acquiring corporation, a result that effectively permits a taxpayer to choose the location of a transferor corporation's attributes by causing the direct transferee corporation either to retain or not to retain a single asset. The IRS and the Treasury Department believe the [amended provision] produces more appropriate results because it … eliminate[s] the electivity." As amended, Reg. § 1.312-11 merely cross-references the § 381 regulations.

4. **Tracking the basis of nonexistent stock ain't easy.** T.D. 9702, Allocation of Basis in All Cash D Reorganizations, 79 F.R. 67059 (11/12/14). The Treasury Department has promulgated final regulations replacing Temp. Reg. § 1.358-2T (T.D. 9558, Corporate Reorganizations; Allocation of Basis in "All Cash D" Reorganizations, 76 F.R. 71878 (11/21/11)) with only nonsubstantive changes. Reg. § 1.358-2 deals with stock basis in all cash type D reorganizations under Reg. § 1.368-2(l). If an actual shareholder of the acquiring corporation is deemed to receive a nominal share of stock of the issuing corporation described in Reg. § 1.368-2(l), that shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of Reg. § 1.358-1, and after adjusting the basis in the nominal share for any transfers described in Reg. § 1.358-1, designate the share of stock of the acquiring corporation to which the basis, if any, of the nominal share will attach. Under these rules, the ability to designate the share of stock of the acquiring corporation to which the basis of the surrendered stock or securities of the target will attach applies only to a shareholder that actually owns shares in the issuing corporation. Thus, for example, if in an all cash D reorganization, Y Corporation, a first tier subsidiary of P Corporation, acquires the assets of T Corporation, a second tier subsidiary of P Corporation, owned by X Corporation, a first tier subsidiary of P Corporation, X Corporation cannot designate any share of Y Corporation stock to which the basis, if any, of the nominal share of Y Corporation stock will attach; and P Corporation cannot designate a share of Y Corporation stock to which basis will attach because P Corporation's basis in the nominal share of Y Corporation stock (deemed to have been distributed to it by X Corporation) is zero (its fair market value).

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

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

> The relationship between the Holding Company and the Bank is not a debtor-creditor relationship. When the Holding Company received the tax refunds, it held the funds intact—as if in escrow—for the benefit of the Bank and thus the remaining members of the Consolidated Group. The parties intended that the

Holding Company would promptly forward the refunds to the Bank so that the Bank could, in turn, forward them on to the Group's members. In the Bank's hands, the tax refunds occupied the same status as they did in the Holding Company's hands—they were tax refunds for distribution in accordance with the TSA.

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

2. Self-help for subsidiaries that fail to consent to the consolidated return regulations by filing Form 1122. Rev. Proc. 2014-24, 2014-13 I.R.B. 879 (3/10/14). This revenue procedure provides guidance on the conditions that must be satisfied to obtain an automatic determination that a subsidiary member of an affiliated group will be treated as if it had filed Form 1122, Authorization and Consent of Subsidiary Corporation to Be Included in a Consolidated Income Tax Return, and thus joined in the group's making of a consolidated return, notwithstanding the subsidiary's failure to file Form 1122. An affiliated group of corporations can elect to file a consolidated return only if each corporation that is a member of the affiliated group for any portion of the group's tax year consents to the consolidated return regulations. Reg. § 1.1502-75(a)(1). For the first tax year in which the group files a consolidated return, each subsidiary group member must give this consent by filing Form 1122. Reg. § 1.1502-75(b)(1), (h)(2). If a subsidiary fails to file Form 1122, it is treated as if it had filed Form 1122 if the IRS determines that the subsidiary joined in the consolidated return or that the subsidiary was excluded due to a mistake of law or fact, or to inadvertence. Reg. § 1.1502-75(b)(2)-(3). The IRS no longer issues private letter rulings (but may issue determination letters) on whether a subsidiary group member will be treated as if it had filed Form 1122. See Rev. Proc. 2014-3, § 3.01(73), 2014-1 I.R.B. 111 (12/30/13). To mitigate the inability of taxpayers to obtain certainty through private letter rulings, the revenue procedure provides that, if certain conditions are satisfied, "it is hereby determined by the Commissioner that a subsidiary that actually failed to file a Form 1122 (non-filing subsidiary) is treated as if it filed Form 1122 and thus joined in the making of a consolidated return by the affiliated group." The conditions are: (1) The affiliated group timely filed what purported to be a consolidated return for the year, including Form 851 (Affiliations Schedule) or providing some other clear and unequivocal indication on the return that it was intended as a consolidated return, (2) The non-filing subsidiary was not prevented from joining in the filing of the consolidated return by any applicable rule of law, other than the failure to file Form 1122, (3) With certain limited exceptions, the non-filing subsidiary did not file a separate return for any period of time included in the consolidated return, or any subsequent taxable year, and (4) One of three specified conditions exists, which generally require that (a) the failure to file Form 1122 was either due to a mistake of law or fact or to inadvertence or caused by the group's belief that the non-filing subsidiary was treated as a partnership, and (b) the non-filing subsidiary's income and deductions were included in the consolidated return. An affiliated group that does not satisfy the requirements for an automatic determination can seek a determination letter. The revenue procedure is effective March 24, 2014.

H. Miscellaneous Corporate Issues

1. Tacking a farm or ranch subsidiary onto your personal services corporation might enable you to beat the flat rate 35 percent corporate tax. Applied Research Associates, Inc. v. Commissioner, 143 T.C. No. 17 (10/9/14). The taxpayers were an affiliated group that filed consolidated returns. The group consisted of a parent that provided professional engineering services, and thus was a qualified personal service corporation, and a subsidiary that conducted a ranching business, and thus was not a qualified personal service corporation. All of the group's consolidated taxable income for the years in question was attributable to the parent personal service corporation. The taxpayer took the position that the group, as a single entity, was not a qualified personal service corporation and computed the tax on its consolidated taxable income using the § 11(b)(1) graduated rates. The IRS took the position that each group member's status as a qualified personal service corporation should be determined separately and calculated the tax on the consolidated taxable income of the group under the § 11(b)(2) flat 35 percent tax rate applicable to qualified personal service corporations. The Tax Court (Judge Jacobs) held that the graduated rates schedule in § 11(b)(1) applied to compute the tax owed by an affiliated group consisting of a qualified personal service corporation and an entity that is not a qualified personal service corporation where the group, as a single entity, was not a personal service corporation. The court rejected the IRS's argument that "where one member of an affiliated group is a qualified personal service corporation and another is not, the consolidated taxable income of the affiliated group must be broken up into two separate baskets"; "that section 448 requires that the determination as to whether a corporation is a qualified personal service corporation is to be made at the entity level, not at the level of the affiliated group." Rather, the court found "no authority to permit the breakup of an affiliated group's consolidated taxable income into separate baskets." It looked at "the affiliated group as a whole, i.e., the entity which generated the consolidated taxable income, to determine the characterization of the consolidated taxable income." When viewed as a whole, the group was not a qualified personal service corporation.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2, but it was too late to keep the Miss America Pageant in Atlantic City. Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events, and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to nineteen large corporations, which described the transaction as a "sale" of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about $57 million to Historic Boardwalk Hall. and Pitney Bowes made capital contributions of more than $18 million to that LLC, as well as an investor loan of about $1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a "development fee" and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

- Judge Goeke held that one of the purposes of § 47 was "to encourage taxpayers to participate in what would otherwise be an unprofitable activity," and the rehabilitation of East Hall was a success, leading to the conclusion that Historic Boardwalk had objective economic substance. He also held that "Pitney Bowes and NJSEA, in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise" and that while the offering memorandum used the term "sale," "it was used in the context of describing an investment transaction." Finally, Judge Goeke used Reg. § 1.701-2(d), 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), *cert. denied*, 133 S. Ct. 2734 (5/28/13). In a unanimous opinion by Judge Jordan, the Third Circuit reversed the Tax Court and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall LLC. The court's reasoning was based on the *Culbertson* test [*Commissioner v. Culbertson*, 337 U.S. 733 (1949)], as applied by the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (*Castle Harbour II*), to find that the Dutch banks were not partners, and the reasoning of the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), to find that the investors who acquired the Virginia Historic Rehabilitation credits through the partnership bore no "true entrepreneurial risk," which the Third Circuit concluded was a characteristic of a true partner under the *Culbertson* test. The Third Circuit concluded that Pitney Bowes was not a partner because, based on an analysis of the facts, as the transaction was structured, (1) Pitney Bowes "had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought — the HRTCs or their cash equivalent," and (2) Pitney Bowes's "avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential." The analysis was highly factual and based on substance over form. As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court's finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3 percent preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund*, the Third Circuit treated the 3 percent preferred return as a "return on investment" that was not a "share in partnership profits," which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that "although in form PB had the potential to receive the fair market value of its interest . . . in reality, PB could never expect to share in any upside." The court noted that it was mindful "of Congress's goal of encouraging rehabilitation of historic buildings," and that its holding might "jeopardize the viability of future historic rehabilitation projects," but the court observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

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

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

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

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

c. The IRS now provides a Safe Harbor under which it will not use its *Historic Boardwalk* victory to challenge allocations of § 47 rehabilitation credits to investor partners. Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (12/31/13). This revenue procedure specifies the conditions under which the IRS will not challenge partnership allocations of § 47 rehabilitation credits. Section 4 of the revenue procedure contains the requirements for the Safe Harbor. It defines investors as partnership partners (other than principals) (§4.01); provides for an investor's minimum partnership interest (§4.02); provides for an investor's minimum unconditional contribution of 20 percent of the investor's total expected capital contribution before the date the building is placed in service (§4.03); and requires that at least 75 percent of the investor's total expected capital contribution be fixed in amount before the building is placed in service (§4.04).

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

2. Even though living on credit is as American as apple pie, there's still no increase in the basis of a partnership interest when the partner contributes his own promissory note to the partnership. VisionMonitor Software, LLC v. Commissioner, T.C. Memo. 2014-182 (9/3/14). The sole issue in this case was whether the contribution to a partnership of a partner's promissory note gave rise to an increase in the partner's basis in the partnership interest under § 722, which would allow partnership level losses to pass through to the partners. Following prior Tax Court precedent, Judge Holmes upheld the IRS's long-standing position that the contribution of a partner's own note to the partnership isn't the equivalent of a contribution of cash, Revenue Ruling 80-235, 1980-2 C.B. 229, and without more, it will not increase the partner's basis in the partnership interest. *Dakotah Hills Offices Ltd. P'ship v. Commissioner*, T.C. Memo. 1998-134 (no increased basis because not cash equivalent and not property in which partner has basis); *Gemini Twin Fund III v. Commissioner,* T.C. Memo. 1991-315 (partner's outside basis not increased by contribution of promissory note), *aff'd without published opinion*, 8 F.3d 26 (9th Cir. 1993); *Oden v. Commissioner*, T.C. Memo. 1981-184 (partner has zero basis in own promissory note), *aff'd without published opinion*, 679 F.2d 885 (4th Cir. 1982). The court rejected the taxpayer's argument that *Gefen v. Commissioner*, 87 T.C.

1471 (1986), supported the argument that the contribution of a partner's own note to the partnership increases the partner's basis in the partnership interest. In *Gefen*, a partner acquired an interest in a limited partnership and executed a limited guaranty under which the partner assumed personal liability to the partnership's existing creditor for her pro rata share of the partnership's recourse indebtedness to that creditor. Pursuant to Reg. § 1.752-1(e), the partner in *Gefen* was entitled to increase her basis in the partnership by the specific amount of the partnership's recourse debt that she personally assumed under the terms of this guaranty. However, accuracy-related penalties were not sustained; the taxpayer in good faith relied on an experienced tax advisor that the court found to be competent.

- The court does not discuss contrary authority in an analogous situation in the corporate context. Section 357(c) requires recognition of gain in an exchange that otherwise qualifies for nonrecognition under § 351 or § 361 if the taxpayer transfers property and the liabilities assumed in the exchange exceed the taxpayer's adjusted basis in the property. Some courts have held that a taxpayer who transfers encumbered property to a corporation in exchange for stock can avoid recognizing gain under § 357(c) by contributing the taxpayer's promissory note for an amount at least equal to the amount by which the liabilities assumed exceed the taxpayer's basis in the property transferred. ***Peracchi v. Commissioner***, 143 F.3d 487 (9th Cir. 1998) (holding that taxpayer has basis in his own promissory note); see also ***Lessinger v. Commissioner***, 872 F.2d 519 (2d Cir. 1989) (holding that *corporation* had basis in the contributed promissory note, which was sufficient for the taxpayer contributing the property and note to avoid gain under § 357(c)).

3. No upside, no downside, no partnership. Chemtech Royalty Associates, L.P. v. United States, 766 F.3d 453 (5th Cir. 9/10/14). The Fifth Circuit, in an opinion by Judge Smith, affirmed a District Court decision that disregarded two partnerships formed by Dow Chemical Company and a number of foreign banks that generated over $1 billion of deductions for Dow. The scheme was very similar to the ***Castle Harbour*** scheme, see ***TIFD III–E, Inc. v. United States***, 459 F.3d 220 (2d Cir. 2006). The District Court disregarded the partnerships for tax purposes on three grounds: (1) the partnerships were shams; (2) the transactions lacked economic substance; and (3) the banks' interests in Chemtech Royalty Associates, L.P. ("Chemtech") were debt, not equity. The Court of Appeals held that under the specific facts of the case, the District Court's finding that Dow lacked the intent to share profits and losses with the foreign banks was not clearly erroneous. The court reasoned that under ***Commissioner v. Tower***, 327 U.S. 280, 286 (1946), ***Commissioner v. Culbertson***, 337 U.S. 733 (1949), and ***Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States***, 659 F.3d 466 (5th Cir. 2011), "the parties, to form a valid tax partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share 'the profits and losses.' If the parties lack either intent, then no valid tax partnership has been formed." The court rejected Dow's argument that a determination of whether an interest qualifies as debt or equity must precede addressing whether under ***Culbertson*** the partnership is a sham, and that the foreign banks were partners rather than creditors because they were "not legally entitled to repayment of their investment even if the banks could recover the value of their partnership share when terminating the partnership." Rather the court expressed no opinion as to whether the banks' interest should be classified as debt, but limited its "inquiry to whether Dow possessed the intent to be partners with the foreign banks, focusing on whether Dow had the intent to share the profits and losses with the foreign banks." That intent did not exist. "First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment 'regardless of the success of the [Chemtech] venture.'" The foreign banks were entitled to 99 percent of the profits until they had received a priority return, but only 1 percent after that. Even if Chemtech did not generate sufficient profits to pay the priority return, the banks were still entitled to 97 percent of the priority return. Second, Dow agreed to bear all of the non-insignificant risks arising from Chemtech's transactions; thus the parties did not intend to share any possible losses. In addition, the agreement included significant assurances to ensure that Dow would not misappropriate or otherwise lose the banks' initial investment. Finally, the foreign banks did not meaningfully share in any potential upside. The possibility that the foreign banks could possibly receive a fraction of certain "residual profits" did not provide any meaningful upside because the likelihood of the venture earning such "residual profits" was remote.

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

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

- *Multiple Parties.* Under Prop. Reg. § 1.752-2(a)(2) where multiple partners bear the economic risk of loss with respect to the same liability, the amount of the liability will be taken into account only once, and if the total amount of liability borne by the partners exceeds the amount of the liability, the economic risk of loss to be borne by each partner would be determined by multiplying the amount of the liability by a fraction determined by dividing the amount of the economic risk of loss of a partner over the sum of the amount of loss borne by all partners. Thus, as illustrated by an example in the proposed regulations, where partner A guarantees the full $1,000 of a bank loan to the AB partnership and partner B guarantees $500 of the liability, the amount of the liability allocable to A is $667 ($1,000 × $1,000/$1,500) and the amount of the liability allocable to B is $333 ($1,000 × $500/$1,500). Prop. Reg. § 1.752-2(i) would be amended to provide that where a liability of a lower-tier partnership is allocated both to the upper-tier partnership and to a partner who bears economic risk of loss as a partner in both the upper-tier and lower-tier partnerships, the basis resulting from such a liability will be allocated directly to the partner of the lower-tier partnership rather than to the upper-tier partnership.

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

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

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

- *Disguised Sales Rules:* The proposed regulations under § 707 provide a number of not particularly controversial clarifications of the § 707 disguised sale rules. (1) An ordering rule would be added in Reg. § 1.707-5 to provide that the treatment of a transfer should first be determined under the debt-financed distribution exception, and any amount not excluded from Reg. § 1.707–3 under the debt financed distribution exception should be tested to see if such amount would be excluded from Reg. § 1.707–3 under a different exception in Reg. § 1.707–4. (2) The exception for preformation capital expenditures in Reg. § 1.707-4 would be clarified to provide expressly that the 20 percent of fair market value ceiling and the exception to the limitation where the fair market value of the property does not exceed 120 percent of basis apply property-by-property. In addition for purposes of Reg. § 1.707-3, the term ''capital expenditures'' would have the same meaning as the term ''capital expenditures'' generally does, *except* that it would include capital expenditures taxpayers elect to deduct, and would not include deductible expenses taxpayers elect to treat as capital expenditures. The proposed regulations also provide a rule coordinating the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures. (3) The proposed regulations add to the list of qualified liabilities that pursuant to Reg. § 1.707-5 may be assumed without triggering the disguised sale rules liabilities that were not incurred in anticipation of the transfer of the property to a partnership, but that were incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred (other than assets that are not material to a continuation of the trade or business). (4) The proposed regulations clarify the anticipated reduction rule in Reg. § 1.707-5(a)(3) by providing that a reduction that is subject to the entrepreneurial risks of partnership operations is not an anticipated reduction. (5) The proposed regulations add additional rules regarding tiered partnerships. (6) The proposed regulations extend the netting of partners' increases and decreases of liabilities principles of Reg. § 1.752–1(f) to determine the effect of a partnership merger under the disguised sale rules.

- *Partners' Shares of Recourse Debt:* For purposes of allocating partnership liabilities generally, Reg. § 1.752–2 adopts an ultimate liability test under a worst-case scenario. Under this test, an otherwise nonrecourse liability of the partnership is allocated as a recourse liability to a partner that guarantees the liability, even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability with either partnership profits or capital. The IRS and the Treasury Department consider that approach inappropriate due to the fact that in most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The IRS and the Treasury Department believe that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner. Accordingly, the proposed amendments to Reg. § 1.752-2 provide that obligations to make a payment with respect to a partnership liability (excluding those imposed by state law) will not be recognized for purposes of § 752 unless certain factors are present. These factors are intended to ensure that the terms of the payment obligation are not designed solely to obtain tax benefits. First, a partner or related person must (a) maintain a commercially reasonable net worth during the term of the payment obligation or (b) be subject to commercially reasonable restrictions on asset transfers for inadequate consideration. Second, the partner or related person must provide commercially reasonable documentation regarding its financial condition. Third, the payment obligation must not terminate prior to the term of the partnership liability. Fourth, the primary obligor or any other obligor must not be required to hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor. Fifth, the partner or related person must receive arm's length consideration for assuming the payment obligation. Sixth, in the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Seventh, in the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied. (The sixth and seventh rules do not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.) These rules would prevent certain so-called ''bottom dollar'' guarantees from being recognized for purposes of § 752. The proposed regulations relating to guarantees and indemnities draw lines that, among other things,

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preclude recognition of a payment obligation for a portion, rather than 100 percent, of each dollar of a partnership liability to which the payment obligation relates. The proposed regulations provide the following example with respect to top and bottom dollar guarantees:

> A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other. ... Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee satisfies the requirement[s] ... . Therefore, A's payment obligation is recognized ... . The amount of A's economic risk of loss ... is $300. However, because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee does not satisfy the requirement[s] ... and B's payment obligation is not recognized. Therefore, B bears no economic risk of loss ... for ABC's liability. As a result, $300 of the liability is allocated to A ... and the remaining $700 liability is allocated to A, B, and C under § 1.752-3.

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

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

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

C. Distributions and Transactions Between the Partnership and Partners

1. Transfer of state rehabilitation tax credits is recognized as a partnership contribution and distribution rather than a sale. Gateway Hotel Partners, LLC v. Commissioner, T.C. Memo. 2014-5 (1/9/14). Gateway Hotel Partners (GHP) was formed to renovate historic hotel properties in St. Louis, Missouri. GHP's members were WAHD, a Missouri LLC that was the operating partner and which contracted with GHP as the developer, and HH, a Texas LLC, the passive investor. WAHD was majority owned and managed by HRI, a New Orleans based real estate developer organized as an S corporation. HRI obtained a bridge loan to finance the project from the Missouri Development Finance Board, which was secured by Missouri State Tax Credits that would be issued by the Finance Board on completion of the hotel projects. The loan agreements with the Finance Board and among the various entities required HRI to contribute the bridge loan proceeds to WAHD, which in turn was contractually required to contribute the proceeds to GHP. However, the money was actually paid directly to GHP. HRI had also contracted to sell the tax credits to another party, ultimately using the sales proceeds to repay the bridge loan. In the first two stages, upon completion of the projects, GHP would distribute the tax credits to WAHD, which in turn would distribute the tax credits to HRI for sale to the third party. GHP's financial statements did not reflect the receipt of a capital contribution from WAHD, nor did WAHD's or HRI's financial statements reflect distributions of the tax credits, which went straight to the ultimate purchaser. The IRS asserted that the bridge loans were made directly to GHP so that distributions to WAHD and/or HRI were not partnership distributions in redemption of partnership capital interests, but represented sales of the tax credits by GHP, which thereby recognized gain on the sales under the substance over form doctrine, the step transaction doctrine, or under disguised sale principles of § 707(a)(2)(B). The Court (Judge Goeke) agreed with the taxpayer that the transfer of the bridge loan proceeds represented a contribution to capital for a partnership interest in GHP by WAHD, notwithstanding the direct payment from the Finance Board undertaken to obviate the necessity of three separate transfers. Examining the whole transaction, the court concluded that both the form and the substance of the bridge loan established that HRI, not GHP, was the borrower. The court further rejected the IRS's assertion that making the bridge loan to HRI was a meaningless step taken to avoid Federal income tax, in part because HRI's better risk profile permitted it to obtain the bridge loan on better terms than would have been available to GHP. It therefore followed that the transfer of the loan proceeds through WAHD represented a capital contribution to GHP. The court further rejected the IRS's assertion that GHP transferred the tax credits directly to the purchaser as a sale under substance over form and step transaction principles, finding instead that GHP's transfer of the tax credits flowed from WAHD's capital contribution, which was not a meaningless or unnecessary step in the transaction, and therefor constituted a distribution. The court also rejected the IRS's argument that the contribution of loan proceeds by WAHD, followed by distribution of the tax credits was a disguised sale under § 707(a)(2)(B). Following the direction of Reg. § 1.707-6, the court applied the facts and circumstances rules of Reg. § 1.707-3, including the presumption that the contribution and distribution to WAHD, which occurred more than two years apart, were not part of a disguised sale. The court analyzed the multiple factors of Reg. § 1.707-3 as follows:

- The authority of the passive partner to determine whether to use cash or property to satisfy WAHD's preferences and uncertainty of amount and timing of distributions meant that the timing and amount of subsequent distributions were uncertain. Reg. § 1.707-3(b)(2)(i).
- The discretion of the passive partner meant that WAHD did not have an enforceable right to the distribution of tax credits. Reg. § 1.707-3(b)(2)(ii).
- The passive partner's discretion to distribute cash or property meant that the rights of WAHD to the money or property were not secured. Reg. § 1.707-3(b)(2)(iii).
- An insurance policy against GHP's receipt of the tax credits did not represent a legal obligation to make contributions to the partnership, which the court interpreted as requiring under Reg. § 1.707-3(b)(2)(iv) an obligation to make a contribution that would provide an equity interest in the partnership. The insurance policy represented an obligation to make a payment in exchange for insurance premiums paid by the partnership.
- The absence of debt incurred or other obligation to incur debt by a third party or the partnership to fund the distribution weighed against disguised sale. Reg. § 1.707-3(b)(2)(v) and (vi).
- The partnership did not have excess liquid assets to fund a distribution. Reg. § 1.707-3(b)(2)(vii).
- The agreements were not designed to transfer ownership rights to the tax credit to WAHD. Reg. § 1.707-3(b)(2)(viii).
- The fact that WAHD had a 1 percent profits interest but received 100 percent of the tax credits indicated that the transfer of tax credits to WAHD bore no relationship to WAHD's interest in GHP profits and thus was a factor indicating disguised sale treatment. Reg. § 1.707-3(b)(2)(ix).

- Also, the fact that WAHD was not required to return the tax credits weighed in favor of disguised sale treatment, Reg. § 1.707-3(b)(2)(x), notwithstanding WAHD's obligation to fund operating deficits, which the court viewed as independent of any requirement to return the tax credits.
- The court was not persuaded that two out of the ten factors that indicated a disguised sale, particularly in light of the first two factors, uncertainty about the amount and timing of the distribution, and the absence of an enforceable right to the distribution, which the court found to be the most compelling factors.
- The court found that a third transfer of tax credits directly from GHP to the purchaser, with the proceeds transferred directly from the purchaser to the Finance Board, that was not documented in the year of the transfer as a distribution, constituted a sale by the partnership.
- The court also held that development fees paid to GHP by WAHD before commencement of operations were a return of principal and therefore not includable in GHP's income.

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

3. As if § 751(b) wasn't already hard enough to understand. REG-151416-06, Certain Distributions Treated as Sales or Exchanges, 79 F.R. 65151 (11/3/14). The IRS and Treasury Department have proposed amendments to the regulations under § 751(b) that would completely change the mechanics of the application of § 751(b). Speaking generally, § 751(b), for example, creates a constructive taxable exchange whenever a partner receives a current distribution that alters the partners' respective interests in unrealized receivables or substantially appreciated inventory (§ 751 property). Section 751(b) generally is intended to prevent partners from allocating among themselves the character of the gain recognized from sales of partnership property. As implemented by the current regulations, § 751(b) is deeply flawed because it measures disproportionality by the value of substantially appreciated inventory and accounts receivable rather than by the built-in gain or loss. Thus, it fails to fulfill completely its stated purpose. These proposed regulations are intended to cure that flaw by amending the § 751(b) regulations to operate similarly to the § 751(a) regulations, which provide generally that a partner's interest in § 751 property is the amount of income or loss from § 751 property that would be allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. The hypothetical sale approach in the proposed § 751(b) regulations, like the approach in the 1999 § 751(a) regulations, shifts the focus away from gross value and to tax gain and loss. Under the hypothetical sale approach, a partner's interest in § 751 property is determined by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property for fair market value immediately before the distribution. The hypothetical sale approach (applying § 704(c) principles) compares: (1) the amount of ordinary income that each partner would recognize if the partnership sold all of its property for fair market value immediately before the distribution, with (2) the amount of ordinary income each partner would recognize if the partnership sold all of its property (and the distributee partners sold the distributed assets) for fair market value immediately after the distribution. If the distribution reduces the amount of ordinary income (or increases the amount of ordinary loss) from § 751 property that would be allocated to, or recognized by, a partner (thus reducing that partner's interest in the partnership's § 751 property), the distribution triggers § 751(b). To make this method work, Reg. § 1.704-1(b)(2)(iv)(f) would be amended to require revaluations of partnership property if the partnership distributes money or other property to a partner as consideration for an interest in the partnership and the partnership owns § 751 property immediately after the distribution. The preamble describes the recognition rules as follows:

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

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

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

The deemed gain approach can require recognition of capital gain in certain cases. Rather than choosing between the alternatives, the IRS and Treasury punted, and the proposed regulations do not require the use of a particular approach for determining the tax consequences of a § 751(b) distribution. Rather, the proposed regulations provide that if, under the hypothetical sale approach, a distribution reduces a partner's interest in the partnership's § 751 property, giving rise to a § 751(b) amount, then the partnership must use a reasonable approach that is consistent with the purpose of § 751(b) to determine the tax consequences of the reduction. Generally a partnership must use one approach consistently (including after a termination of the partnership under § 708(b)(1)(B)). Examples illustrate situations in which the approach adopted is reasonable and in which it is not reasonable. The proposed regulations include extensive provisions dealing with the impact of § 734(b) and § 743(b) basis adjustments, both those that pre-exist the distribution that triggers § 751(b) as well as those that arise from the distribution. The proposed regulations require a distributee partner to recognize capital gain to the extent necessary to prevent the distribution from triggering a basis adjustment under § 734(b) that would reduce other partners' shares of net unrealized § 751 gain or loss. The proposed regulations also allow distributee partners to elect to recognize capital gain in certain circumstances to avoid § 732 decreases to the basis of distributed § 751 property. [We are not masochistic enough to attempt to describe in detail all of those rules herein.] The proposed regulations also contain complex anti-abuse rules that apply when a partner engages in a transaction that relies on § 704(c) to eliminate or reduce ordinary income. All of the rules in the proposed regulations are beyond comprehension without reference to the numerous examples.

D. Sales of Partnership Interests, Liquidations and Mergers

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

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

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

a. The Fifth Circuit affirms—still no bingo for Mingo. Mingo v. Commissioner, 2014 WL 6914367 (5th Cir. 12/9/14). In an opinion by Judge Graves, the Fifth Circuit affirmed and ruled in favor of the government on the same grounds as the Tax Court. The Fifth Circuit relied on *Sorensen v. Commissioner*, 22 T.C. 321 (1954) and held that "the proceeds from the unrealized receivables, classified as ordinary income, do not qualify for installment method reporting because they do not arise from the sale of property." Accordingly, the court held, the taxpayer should have reported ordinary income of $126,240 in 2002, the year in which she sold her partnership interest. The court also held that the IRS properly changed the taxpayer's method of accounting and made a § 481(a) adjustment with respect to the unrealized receivables in 2003 despite the fact that the limitations period on assessment of tax for 2002 had expired. The court cited its prior opinion in *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568 (5th Cir. 1965) for the proposition that "[t]he Commissioner has ample power to change accounting methods and reassess income for open years; section 481 would be virtually useless if it did not affect closed years."

2. A partnership termination is only a termination for some purposes. T.D. 9681, Partnerships; Start-up Expenditures; Organization and Syndication Fees, 79 F.R. 42679 (7/23/14). The Treasury Department has finalized amendments to Reg. §§ 1.195-2(a), 1.708-1(b)(6), and 1.709-1(b)(3) proposed in REG-126285-12, 78 F.R. 73753 (12/9/13), providing that on a technical termination of a partnership under § 708(b)(1)(B) caused by a sale or exchange of 50 percent or more of partnership interests within a 12-month period, the new partnership deemed to be formed as a continuation of the terminated partnership under Reg. § 1.708-1(b)(4), will continue to amortize § 195 start-up expenses and § 709 organization expenses using the same amortization period adopted by the terminated partnership. The amended regulation clarifies that the terminated partnership may not claim a § 165 loss deduction for any unamortized start-up or organization expenses. The IRS reasoned in the Preamble to the proposed regulations that the technical termination of a partnership under § 708(b)(1)(B) is not a cessation of the trade or business to which the start-up and organizational expenses relate. The Preamble to the proposed regulations also points out that this treatment is consistent with the amortization of § 197 intangibles to the extent of the transferor's adjusted basis, which continues in the new partnership over the remainder of the transferor's 15-year amortization period. The amended regulations apply to technical terminations that occur after 12/9/13.

E. Inside Basis Adjustments

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

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

- The proposed regulations under § 734(b) elaborate on the statute principally with respect to tiered partnerships and, in Prop. Reg. § 1.734-2(c), with respect to basis adjustments after a distribution to a contributing partner or a transferee partner.
- The proposed regulations under § 743(b) elaborate on the application of the provision to tiered partnerships and substitute basis provisions and provide detailed rules for the exception for electing investment partnerships.
- Proposed amendments to Reg. § 1.737-1(c) would provide that a § 708(b)(1)(B) technical termination of a partnership does not begin a new seven-year period for each partner with respect to built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under Reg. § 1.708-1(b)(4).
- All of the above proposed regulations generally would be effective upon finalization.
- Proposed amendments to the regulations under § 755 would provide that the transferee in a substituted basis transaction succeeds to that portion of the transferor's basis adjustment attributable to the transferred partnership interest and that the adjustment is taken into account in determining the transferee's share of the adjusted basis to the partnership for purposes of §§ 1.743-1(b) and 1.755-1(b)(5). The proposed amendments (Prop. Reg. § 1.755-1(b)(5)) also deal with allocating § 743(b) basis adjustments resulting from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest and from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. The new rules would apply, for example, if a partnership interest is contributed to a corporation in a transaction to which § 351 applies, if a partnership interest is contributed to a partnership in a transaction to which § 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which § 731(a) applies. The proposed amendments to the § 755 regulations have varying retroactive effective dates, mostly reaching back to 12/15/99, but some retroactive to 6/9/03, and others effective 1/16/14.

F. Partnership Audit Rules

1. The IRS gets a second bite at this TEFRA apple even if the in-house rules were not followed. NPR Investments, LLC v. United States, 732 F. Supp. 2d 676 (E.D. Tex. 8/10/10). NPR was a partnership formed to execute an R.J. Ruble, Sidley Austin, Son-of-Boss abusive tax shelter deal. The three partners were partners in a plaintiff's contingency fee law firm, and two of them were the taxpayers in ***Klamath Strategic Investment Fund, LLC v. United States***, 568 F.3d 537 (5th Cir. 5/21/09). When the partners withdrew from NPR, they transferred the inflated basis foreign currency from NPR to their law firm partnership. On its tax return, NPR indicated that it was not a partnership subject to TEFRA audit procedures, when in fact it was a TEFRA partnership. In the initial audit of NPR's returns, the IRS applied normal partnership audit procedures and issued a final no-adjustment notice to the partnership. Rather than proposing adjustments to the NPR return, the IRS determined that it would deny loss deductions through the issuance of notices of deficiency directly to the NPR partners. In a higher-level review, the IRS determined that NPR was a TEFRA partnership and that the deficiency action required issuance of an FPAA to the NPR partners adjusting NPR partnership items. Section 6223(f) provides that if the IRS mails a notice of final partnership administrative adjustment, it may not mail another notice in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact. The taxpayers argued that the second notice was invalid. The court (Judge Ward) found that the initial notice to NPR met the statutory criteria for an FPPA, even though it was sent through the normal audit process. The court indicated that there is nothing in statute or case law that affects the validity of an FPPA by whether the IRS followed proper internal procedures in issuing the notice. However, the court also found that the taxpayer's misrepresentation of the TEFRA audit status on NPR's partnership return by failing to check the box indicating it was subject to the TEFRA provisions was a "misrepresentation of a material fact" invoking the exception in § 6223(f) that allows a second notice.

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

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

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

3. Jail, death, and taxes go hand in hand with cemetery plots. McElroy v. Commissioner, T.C. Memo. 2014-163 (8/12/14). The Petitioner invested in three partnerships, each lasting a single year, that acquired cemetery plots costing $95,639, $169,167, and $252,373. Each partnership contributed the plots to charitable organizations and passed through claimed charitable contribution deductions for the appraised value of the plots in the amounts of $1,864,850, $2,936,700, and $5,282,050, respectively. Each partnership held the plots for less than one year. Each partnership timely filed returns for its tax years, 1996, 1997, and 1998. The Petitioner claimed charitable contribution deductions on his individual 1996, 1997, and 1998 returns and a carryover loss on his individual 1999 return. The IRS mailed FPAA's to the respective partnerships on March 31, 2000, April 11, 2001, and March 29, 2002. The promoter and tax matters partner, Glenn R. Johnston, refused to agree to an extension of the statute of limitations with respect to the first partnership, indicating that he was then under criminal investigation. Johnston filed timely petitions with the Tax Court regarding the FPAA's in 2000, 2001 and 2002. In 2005 Johnston pleaded guilty to one count of conspiracy to defraud the United States. On motion by the IRS, Johnston, who was incarcerated, was replaced as the TMP by Petitioner who served in that capacity until Petitioner filed for bankruptcy in 2012. The partnership proceeding was concluded in 2013 and Petitioner's charitable contribution deductions were substantially reduced to a portion of the partnership's basis in the cemetery plots. On March 31, 2011, the IRS mailed a notice of deficiency to Petitioner. The court (Judge Nega) rejected Petitioner's argument the notice of deficiency was barred by the statute of limitations. The three year limitations of § 6501(a) is suspended with respect to partnership items subject to TEFRA under § 6229(a) until one year after the decision in a partnership proceeding becomes final. Also, under § 6229(f) the three-year statute is extended if a partner is named as a debtor in a bankruptcy proceeding and partnership items are declared nonpartnership items as of the day a bankruptcy petition is filed. In that case the IRS has one year from the date of the filing to assess tax attributable to the converted items. Petitioner asserted that the partnership proceedings were invalid because on the dates the FPAA's were issued the then TMP, Johnston, was under criminal investigation, was disqualified to serve as TMP and could not properly commence the partnership proceedings. Alternatively, Petitioner argued that the partnership proceedings terminated earlier than the decision date because the IRS knew that Johnston could not participate as TMP. The court held that a challenge to the validity of an FPAA and the conduct of the proceeding were "typically" matters to be raised in the partnership proceeding and noted that the court in those proceedings did not find the FPAA's to be invalid nor did the court find improprieties in those proceedings. The court further indicated that filing of petitions as to the FPAA's suspended the statute of limitations regardless of the validity of the petitions under § 6229(d), requiring only that petitions be filed to suspend the statute of limitations. In addition, even if Mr. Johnston were not qualified to act as TMP, he could have filed the petitions as a notice partner. The court also rejected the argument that the partnership proceeding terminated earlier than the date of final decision, which is derived from § 7459(c). When Petitioner filed his bankruptcy petition during the pendency of the partnership proceedings, Petitioner's partnership items became nonpartnership items and the IRS had one year from the date of the filing to mail the Notice of Deficiency, which it did.

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

4. Tread lightly. Missteps by the IRS and taxpayer's representative deprive the Tax Court of jurisdiction. This case demonstrates the problems created for TEFRA by abusive shelters. Bedrosian v. Commissioner, 143 T.C. No. 4 (8/13/14). This long, convoluted opinion (Judge Buch), reviewed by the court, examines an equally convoluted procedural morass that was created by IRS examinations which issued both a Final Partnership Administrative Adjustment (FPAA) and a notice of deficiency involving the same partnership items in a Son-of-Boss partnership. At the outset the taxpayers were advised that their 1999 return was selected for audit and, at the request of the IRS, the taxpayers executed a Form 872 extending the statute of limitations and a Form 2848 appointing representatives. No such forms were executed regarding Stone Canyon, the partnership through which the Son-of-Boss transaction was executed. The parties agreed that the Form 872 did not extend the limitations period for assessment of tax attributable to partnership items and affected items of Stone Canyon for tax year 1999. The IRS also examined the taxpayers' 2000 return, which had a small carryover attributable to the partnership. In the 2000 case the taxpayers executed a Form 872-I that extended the limitations period to assess tax including tax attributable to items of a partnership for 2000. The revenue agent contacted the taxpayers' representative and told her that the IRS would soon issue a Notice Of Beginning Of Administrative Proceeding (NBAP) with respect to Stone Canyon for 1999, then issued the NBAP by mailing the notice to the taxpayers, but not their representative because no power of attorney was submitted for Stone Canyon. In

April 2005 the IRS mailed the FPAA to the taxpayers, Stone Canyon, and the pass-through entities designated as partners in Stone Canyon, sending the FPAA to fourteen different addresses. The FPAA included a notice indicating that the FPAA was untimely under § 6223(e) because it was issued only 61 days following the NPAB and that the taxpayer could "elect" under § 6223(e) to opt out of the partnership proceeding. Eleven days later, the IRS issued a notice of deficiency to the taxpayers assessing tax for the same partnership items that were the subject of the FPAA. The taxpayers filed a timely petition with the Tax Court contesting the 2005 notice of deficiency, and also made a payment of $4,269,819 to the IRS. Responding to a motion by the IRS, the Tax Court held that it lacked jurisdiction to hear the taxpayers' petition because the 2005 notice of deficiency was invalid as addressing partnership items or affected items subject to TEFRA actions. ***Bedrosian v. Commissioner***, T.C. Memo. 2007-375. The court suggested, however, that it retained continuing jurisdiction to consider nonpartnership items. The IRS also issued in 2006 an affected items notice of deficiency to the taxpayers. In response to the taxpayers' petition to the Tax Court in response to the 2006 notice, the court held that it lacked jurisdiction to consider the deficiencies because they had been paid and assessed prior to the issue of the 2006 notice. ***Bedrosian v. Commissioner***, T.C. Memo. 2007-376. In 2007 the taxpayers filed an untimely petition in response to the FPAA. The Tax Court rejected the taxpayers' argument that the FPAA was invalid because it was sent to the wrong address and dismissed the untimely petition for lack of jurisdiction. ***Stone Canyon Partners v. Commissioner***, T.C. Memo. 2007-377. These decisions collectively were affirmed by the Ninth Circuit. ***Bedrosian v. Commissioner***, 358 Fed. Appx. 868 (9th Cir. 2009). Finally, in the instant case, after granting leave to amend, the Tax Court rejected the taxpayers' motion for summary judgment and held that the court lacked jurisdiction to consider the partnership items. The taxpayers argued that the partnership items should be considered nonpartnership items under § 6223(e), and at the request of the court, also argued that the court had jurisdiction to consider the partnership items under § 6231(g)(2).

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

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

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

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

5. The simplification of partnership audits enacted in TEFRA continues to make partnership audits ever-more complex and procedurally mysterious. JT USA, LP v. Commissioner, 771 F.3d 654 (9th Cir. 11/14/14). The Ninth Circuit, in a 2-1 opinion by Judge Trott, reversed the Tax Court's holding (131 T.C. 59 (2008)) that a taxpayer holding both direct and indirect interests in a partnership may elect under § 6223(e)(3)(B) not to be bound by the results of a TEFRA partnership proceeding as to some, but not all, of those interests held during the relevant taxable year. The taxpayers had elected to opt out of the partnership proceeding with respect to their indirect interests but to leave in that proceeding their alleged remaining direct partnership interests. If the taxpayers' elections to opt out only as indirect partners were effective, the assessment of about $10 million of deficiencies resulting from about $36.6 million in adjustments would have been time-barred. The majority held that unless a partner elects to have all of his or her partnership items treated as nonpartnership items, the partner cannot elect out of the TEFRA proceeding, reasoning that the TEFRA "provisions were enacted *inter alia* to prevent the waste of time, effort, and resources occasioned by a multiplicity of proceedings such as would occur if the Tax Court's construction of § 6223(e) were to prevail. In a normal case the Tax Court's ruling here would permit 'duplicative proceedings and the potential for inconsistent treatment to partners in the same partnership,' thus hindering the purpose and policy justifications that produces TEFRA." Furthermore, it upheld and applied Temp. Reg. § 301.6223(e)-2T(c)(1), which provides that "the election shall apply to *all* partnership items for the partnership taxable year to which the election relates." (Emphasis supplied by the court.) Judge Callahan dissented. He concluded that TEFRA allows one partner to make one election and another partner to make a different election, and that a partner who has both direct and indirect interests should have the same option, particularly where, as in this case, the IRS failed to timely notify the taxpayer that a bifurcated election is ineffective.

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. 219 (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 a 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 and Gilchrist and KPMG John Doe summonses 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 because of (1) 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.

a. Affirmed by the D.C. Circuit. Gaughf Properties L.P. v. Commissioner, 738 F.3d 415 (D.C. Cir. 12/27/13), *aff'g* 139 T.C. 219 (9/10/12). In an interlocutory appeal, the D.C. Circuit (Judge Henderson) affirmed the Tax Court and held that the Gaughfs were "unidentified partners" who took positions on their own tax returns that were inconsistent with those of the partnership in its returns.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

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

a. *Castle Harbour I*: District Court holds for the taxpayer. The court found that the creation of Castle Harbour, a Nevada LLC, by General Electric Capital Corp. subsidiaries was not designed solely to avoid taxes, but to spread the risk of their investment in fully-depreciated commercial airplanes used in their leasing operations. GECC subsidiaries put the following assets into Castle Harbour: $530 million worth of fully-depreciated aircraft subject to a $258 million non-recourse debt; $22 million of rents receivable; $296 million of cash; and all the stock of another GECC subsidiary that had a value of $0. Two tax-indifferent Dutch Banks invested $117.5 million in Castle Harbour. Under the LLC agreement, the tax-indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

- The book income was net of depreciation and the tax income did not take depreciation into account (because the airplanes were fully depreciated for tax purposes). Depreciation deductions for book purposes were on the order of 60 percent of the rental income for any given year.
- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some "economically substantial" upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about $310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about $62 million.
- Query whether § 704(b) was properly applied to this transaction?
- This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.
- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately $62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that "by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income." Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to "re-depreciate" the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation. Nevertheless, the court upheld the allocations. "The tax benefits of the … transaction were the result of the allocation of large amounts of book income to a tax-neutral entity, offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not – and cannot – dispute that partners may allocate their partnership's income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And … the bare allocation of a large interest in income does not violate the overall tax effect rule."
- Judge Underhill concluded:

> The government is understandably concerned that the Castle Harbour transaction deprived the public fisc of some $62 million in tax revenue. Moreover, it appears likely that one of GECC's principal motivations in entering into this transaction—though certainly not its only motivation—was to avoid that substantial tax burden. Nevertheless, the Castle Harbour transaction was an economically real transaction, undertaken, at least in part, for a non-tax business purpose; the transaction resulted in the creation of a true partnership with all participants holding valid partnership interests; and the income was allocated among the partners in accordance with the Internal Revenue Code and Treasury

Regulations. In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws.

b. ***Castle Harbour II*: Second Circuit reverses.** 459 F.3d 220 (2d Cir. 8/3/06). The Second Circuit, in an opinion by Judge Leval, held that the Dutch banks were not partners because their risks and rewards were closer to those of creditors than partners. He used the facts-and-circumstances test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), to determine whether the banks' interest was more in the nature of debt or equity and found that their interest was overwhelmingly in the nature of a secured lender's interest, "which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits."

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

c. ***Castle Harbour III*. Judge Underhill still likes GE. On remand in *Castle Harbour*, the District Court found a valid partnership to have existed under § 704(e) because the heading does not alter the clear language of a statute. A valid family partnership is found in the absence of a family. Additionally, in his contingent penalty findings, Judge Underhill stated that his 2004 taxpayer-favorable decision *ipso facto* means that the taxpayer's reporting position was based upon substantial authority.** 660 F. Supp. 2d 367 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09). In a carefully-written[11] opinion, Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the *Culbertson* totality-of-the-circumstances test ("whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not address the § 704(e)(1) issue. He held that the Dutch banks did satisfy the requirements of that paragraph, which reads:

> (e) Family partnerships.
>
> (1) Recognition of interest created by purchase or gift. – A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

- In so holding, he relied upon well-settled law that the title of a statute cannot limit the plain meaning of the text, and that the title is of use only when it sheds light on some ambiguous word or phrase. *See also* I.R.C. § 7806(b).
- It is worth noting that although *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), which Judge Underhill relied upon extensively to reach his conclusion, held that the application of § 704(e)(1) was not limited to the context of family partnerships, *Evans* involved the question who, between two different persons —the original partner

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

or an assignee of the original partner's economic interest—was the partner who should be taxed on a distributive share of the partnership's income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill's decision in *Castle Harbour III* is the very first case ever to discover that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. On government motions, Judge Ward refuses to vacate partial summary judgment decision on the retroactivity of the regulations under § 752, and he permits the deduction of operational expenses – despite his earlier finding that the

transactions lacked economic substance – because the taxpayers had profit motives. Klamath Strategic Investment Fund, LLC v. United States, 99 A.F.T.R.2d 2007-2001 (E.D. Tex. 4/3/07). First, Judge Ward held that even though the loans lacked economic substance, they still existed, and thus the partial summary judgment on the non-retroactivity of the regulations under § 752 was not premised on invalid factual assumptions. Second, he held that the existence of profit motive for deduction of operational expenses was based on the purposes of Nix and Patterson – and not on the motives of Presidio, the managing partner of the partnership.

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

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

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

d. **A small lagniappe to the taxpayers in a tax shelter.** Klamath Strategic Investment Fund, LLC v. United States, 110 A.F.T.R.2d 2012-6021 (E.D. Tex. 9/24/12). On appeal, the Fifth Circuit Court of Appeals disallowed losses generated by a BLIPS tax shelter investment which was held to lack economic substance. *Klamath Strategic Investment Fund, LLC v. United States*, 568 F.3d 537 (5th Cir. 2009). The Court of Appeals remanded the case to the District Court to determine whether partnership operational expenses of $903,000 and fees for investment advice to the partner investors were deductible under § 212. Based on findings by the trial court, the Court of Appeals indicated that although the transaction lacked economic substance, the profit motive of the individual investors would permit the deduction of their economic outlays if the investors effectively controlled the partnership activities so that their profit motive would be attributable to the partnership. (The managing partners were held to have lacked the necessary profit motive to support the deductions.) The District Court (Judge Gilstrap) found that the partnerships were formed to effect an investment strategy selected by the investors, the managing partners were the managing partners "only because [the investors] said so," the managing partners were confined to the investment strategy directed by the investors "who could shut down the whole process by withdrawing from the partnerships they had created." The court thus held that the investors were the parties having effective control over the partnerships. The court also held that $250,000 of investment fees paid to investment advisors who provided guidance with respect to the partnership's foreign currency investments were deductible. The court concluded from its reading of the Court of Appeals remand that it had jurisdiction to order the refund in the partnership proceeding notwithstanding the fact that the expenses were not paid or incurred by the partnerships.

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

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

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

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

a. But the First Circuit says Judge Goeke misunderstood Massachusetts law and tells him to try a different analysis. Frank Sawyer Trust of May 1992 v. Commissioner, 712 F.3d 597 (1st Cir. 3/29/13). The First Circuit, in an opinion by Judge Lynch, vacated and remanded the Tax Court's decision. The Court of Appeals held that the Tax Court correctly looked to Massachusetts law to determine whether the Trust could be held liable for the corporations' taxes and penalties, rejecting the IRS's argument that the Tax Court should have applied the federal tax substance-over-form doctrine to determine whether the Trust should be considered a "transferee" of the four corporations' assets. However, the Court of Appeals held that the Tax Court erred in construing Massachusetts fraudulent transfer law (which is the Uniform Fraudulent Transfer Act) to require, as a prerequisite for the Trust's liability, either (1) that the Trust knew of the new shareholders' scheme or (2) that the corporations transferred assets directly to the Trust. The IRS had presented evidence of fraudulent transfers from the four corporations to the midco entities, and the midco entities purchased the four corporations from the Trust. The Court of Appeals concluded that if on remand the Tax Court were to find that at the time of the purchases, the assets of these midco entities were unreasonably small in light of their liabilities and that the midco entities did not receive reasonably equivalent value in exchange for the purchase prices, then the Trust could be held liable for taxes and penalties assessed upon the four corporations regardless of whether it had any knowledge of the new shareholders' scheme.

b. **On remand, Judge Goeke imposes transferee liability but limits the transferee's liability to the excess value it received.** Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2014-59 (4/3/14). On remand from the First Circuit, the Tax Court (Judge Goeke) held that the Trust was liable as transferee of a transferee for unpaid taxes, interest and penalties of the corporations whose stock the Trust sold, but that the amount of the Trust's liability was less than the amount asserted by the IRS in its notices of liability. Under Massachusetts fraudulent transfer law (which is the Uniform Fraudulent Transfer Act), as interpreted by the First Circuit, the Trust received a fraudulent transfer from the Fortrend acquisition vehicles if two criteria were satisfied: "(1) the corporation (i.e., Fortrend) did not receive a reasonably equivalent value in exchange for the transfer and (2) the corporation either (i) was engaged or was about to engage in a business or transaction for which the remaining assets were unreasonably small, or (ii) intended to incur, believed, or reasonably should have believed that it would incur, debts beyond its ability to pay as they became due. Judge Goeke held that both criteria were satisfied. Fortrend did not receive reasonably equivalent value because it paid the Trust more than the net book value of the corporations. The corporations that Fortrend purchased possessed only cash and liabilities for taxes. Judge Goeke concluded that the amount Fortrend paid in excess of net book value was not attributable to synergy, goodwill, or going concern value and that Fortrend "did not legitimately and reasonably expect its tax avoidance strategy [to reduce the corporations' tax liabilities] to succeed." Because Fortrend had no legitimate expectation that its tax reduction strategy would work, it should have known that purchasing the corporations would cause Fortrend to incur debts beyond its ability to pay as they became due. Accordingly, the Trust was liable for the unpaid taxes, interest and penalties as a transferee of a transferee.

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

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

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

> [W]e must now assess whether the Shareholders had actual or constructive knowledge of the entire scheme. The Tax Court concluded they did not. This assessment is a mixed question of law and fact, assessing whether based upon the facts as determined by the Tax Court, the Shareholders had constructive or actual knowledge as a matter of law. Therefore, we review de novo the Tax Court's determination that the Shareholders did not have constructive knowledge, but review for clear error the factual findings that underpin the determination.
>
> Concluding that a party had constructive knowledge does not require a showing that the party had actual knowledge of a scheme; rather, it is sufficient if, based upon the surrounding circumstances, they "should have known" about the entire scheme. *HBE Leasing*, 48 F.3d at 636 (internal quotation marks omitted). Constructive knowledge in this context also includes "inquiry knowledge"—that is, where transferees "were aware of circumstances that should have led them to inquire further into the circumstances of the transaction, but ... failed to make such inquiry. . . .
>
> The Tax Court did not sufficiently address the totality of the circumstances from all of the facts, which that court had already laid out itself. ... [i]t is of great import that the Shareholders recognized the "problem" of the tax

> liability arising from the built-in gains on the assets ... . The Shareholders specifically sought out parties that could help them avoid the tax liability inherent in a C Corp holding appreciated assets. ... The parties to this transaction were extremely sophisticated actors, deploying a stable of tax attorneys from two different firms in order to limit their tax liabilities. ... Considering their sophistication, their negotiations with multiple partners to structure the deal, their recognition of the fact that the amount of money they would ultimately receive for an asset or stock sale would be reduced based on the need to pay the C Corp tax liability, and the huge amount of money involved, among other things, it is obvious that the parties knew, or at least should have known but for active avoidance, that the entire scheme was fraudulent and would have left Double D unable to pay its tax liability.
>
> . . . To conclude that these circumstances did not constitute constructive knowledge would do away with the distinction between actual and constructive knowledge, and, at times, the Tax Court's opinion seems to directly make this mistake. The facts in this case strongly suggest that the parties actually knew that tax liability would be illegitimately avoided, and in any event, as a matter of law, plainly demonstrate that the parties "should have known" that this was a fraudulent scheme, designed to let both buyer of the assets and seller of the stock avoid the tax liability inherent in a C Corp holding appreciated assets and leave the former shell of the corporation, now held by a Midco, without assets to satisfy that liability.

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

a. And the Ninth Circuit sees it the same way. Salus Mundi Foundation v. Commissioner, ___ F.3d ___, 2014 WL 7240010 (9th Cir. 12/22/14), reversing and remanding *Salus Mundi Foundation v. Commissioner*, T.C. Memo. 2012-61. In an opinion by Judge Noonan, the Ninth Circuit reversed the same Tax Court decision that was reviewed in *Diebold Foundation, Inc. Commissioner*, 736 F.3d 172 (2d Cir. 11/14/13). In the transaction at issue, the Diebold Foundation sold corporate stock in a midco transaction and made a liquidating distribution of the sale proceeds to three separate foundations organized by the Diebold children in Arizona, Connecticut, and South Carolina. The Tax Court's decision in favor of the foundations therefore was appealable to the Ninth, Second, and Fourth Circuits. This decision addresses the government's appeal of the Tax Court's decision in favor of the foundation organized in Arizona, the Salus Mundi Foundation. Like the Second Circuit, the Ninth Circuit concluded that the two prongs of § 6901 are independent and that "an alleged transferee's substantive liability is determined solely with reference to state law, without any threshold requirement that the disputed transactions be recast under federal law." The Ninth Circuit "adopt[ed] the reasoning of [the Second Circuit's *Diebold*] opinion and conclude[d] that the shareholders had constructive knowledge of the tax avoidance scheme and made a fraudulent conveyance under New York law." The court concluded that the state law liability prong of § 6901 was satisfied and remanded for a determination of the Salus Mundi Foundation's status as a transferee and whether the IRS had assessed liability with the applicable limitations period.

5. The mighty sword of economic substance strikes down yet another tax shelter. This is getting to be really old news. Blum v. Commissioner, 737 F.3d 1303 (10th Cir. 12/18/13). The taxpayer sold a business and recognized a capital gain of approximately $45 million. KPMG, which had already been preparing the taxpayer's tax returns for a few years, then sold him an OPIS tax shelter to reduce his taxes. The Tenth Circuit was unconcerned with the technical mechanics of the transaction and described the deal as follows:

> The OPIS shelter is designed to create large, artificial losses for taxpayers by allowing them to claim a large basis in certain assets. These artificial losses offset

> actual capital gains, reducing the tax liability of the participating taxpayer. ...There are technical rules that allow certain related parties in a financial transaction to claim a basis that, in reality, does not reflect the amount that the party paid for the asset. In fact, the party might not have actually purchased the asset at all. OPIS took advantage of this technical rule to allow clients to pay a relatively small amount of money in order to claim a disproportionately large basis and to use that basis to shelter their own otherwise taxable income. See generally Staff of S. Comm. on Gov't Affairs, Permanent Subcomm. on Investigations, 108th Cong., Rep. on U.S. Tax Shelter Industry 5-10, 28 (Comm. Print 2003) [hereinafter Senate Report].
>
> Individual components of this transaction presented the possibility of profit. No one, however, argues that profits were likely. Indeed, while the parties dispute the method used to calculate the likelihood of profit, both agree profits were unlikely. Rather, according to Mr. Blum, the small chance of huge profits justified the risk of such an investment.

- The court concluded as follows:

> We are unconvinced [that Mr. Blum lacked the subjective motivation to generate a profit from OPIS] and find ourselves arriving at the same conclusion arrived at by the IRS, the U.S. Senate Committee on Governmental Affairs, and the Tax Court. The OPIS transaction in this case was a sham designed to reduce Mr. Blum's tax liability, and it lacked any reasonable probability of generating a profit.

- A gross misvaluation penalty, as well as a negligence penalty, was upheld. "Mr. Blum still relied on a company that was not independent, he signed an opinion letter that he knew or should have known contained a material misrepresentation, and he claims to have relied on advice that he didn't receive until after he filed his taxes."

6. Son-of-BOSS with a midco twist fails. Markell Co. v, Commissioner, T.C. Memo. 2014-86 (5/13/14). The Tax Court (Judge Holmes) held that a midco transaction combined with a digital option Son-of Boss transaction failed to create a loss to offset the gains on the sale of taxpayer's assets.

7. Another midco deal is good enough to be true for the target's shareholders. Julia R. Swords Trust v. Commissioner, 142 T.C. No. 19 (5/29/14). In yet another midco transaction, the Tax Court (Judge Marvel) declined to impose § 6901 transferee liability on the shareholders of the target corporation. In this case the target corporation was a family holding corporation (Davreyn) that held stock in Alcoa. To simplify the complex series of transactions, a grantor trust, the owner of which was the midco, purchased all of the Davreyn stock from the taxpayers. As described by the court "With the benefit of hindsight, it now appears that Alrey Trust and Alrey Acquisition were established to participate in a preplanned series of interrelated transactions designed to illegitimately avoid tax on Alrey Trust's sale of Davreyn's Alcoa stock, which it had acquired as a liquidating distribution. Alrey Trust sold the Alcoa stock incident to receiving it and reported that the substantial gain on the sale was offset by an artificial loss resulting from what appears to have been a Son-of-Boss transaction by Alrey Acquisition, the grantor of Alrey Trust." Notwithstanding this description of the shenanigans (our terminology), Judge Marvel declined "to reconfigure [the transaction] in a way that makes the assets of petitioner trusts a source of collection for tax liabilities originally imposed on Alrey Trust and Alrey Acquisition." The reasoning, however, turned entirely on the application of state law. As an initial proposition, the opinion states "We hereinafter assume (but do not decide) that Davreyn is liable for the tax as determined in the notice of deficiency and that petitioner trusts are 'transferees' within the meaning of section 6901, and we confine our discussion to the parties' dispute on whether applicable State law and/or State equity principles hold petitioner trusts liable for Davreyn's unpaid Federal income tax." The critical issue was whether the court would adopt the IRS's "proposed two-step analysis to decide whether a transaction should be recast under the Federal substance over form (or similar) doctrine when analyzing whether a transferee is liable under section 6901." Judge Marvel recounted that the Tax Court approach has been "to require that State law allow such a transaction to be recast under a substance over form (or similar) doctrine before doing so." The opinion went on to find that "the record fails to establish that an independent basis exists under applicable State law or State equity principles for holding petitioner trusts liable for Davreyn's unpaid tax and that holding would remain the same even if we decided that Davreyn is liable for the tax as determined in the notice of deficiency." Judge Marvel was "unpersuaded that the Supreme Court of Virginia would apply a substance over form analysis to the present setting because, as respondent asserts, petitioner trusts and/or their representatives had actual or constructive knowledge of Alrey Trust's plan to sell the Alcoa stock and to illegitimately avoid any resulting tax liability." "There is no credible evidence … that either petitioner trusts or their representatives knew about any plan on the part of the buyer to illegitimately avoid the payment of tax on the sale of Davreyn's Alcoa stock, and the representatives' knowledge that an unrelated buyer planned to offset any gain from a sale of the Alcoa stock with incurred or anticipated losses is insufficient to show the existence of a preconceived plan by petitioner trusts to illegitimately avoid tax."

8. OPIS, Schmopis, taxpayers fighting denial of tax shelter losses continue to be in denial. Reddam v. Commissioner, 755 F.3d 1051 (9th Cir. 6/13/14), *aff'g* T.C. Memo. 2012-106. In an unsurprising opinion by Judge Hurwitz, the Ninth Circuit affirmed the denial of deductions claimed to have been generated in a KPMG OPIS tax shelter on the ground that the transaction lacked economic substance. The record supported the Tax Court's factual conclusion that the taxpayer pursued the OPIS product solely for its tax benefits. The taxpayer failed to investigate the transaction and "KPMG's marketing materials state[d] that the OPIS transaction 'minimizes gain, or maximizes loss,' an anathema to a profit-seeking investor." Furthermore, "the evidence [was] so overwhelming that no objective investor or taxpayer would enter into the OPIS transaction for its profit making potential." "[T]he small percentage chance that [the taxpayer's] OPIS transaction could have created a sizeable economic gain in return for his multi-million dollar investment pales in comparison to the expectation that it would always create a tax loss of $42,000,000 to $50,000,000. No matter how the underlying Deutsche Bank stock performed, the OPIS transaction was designed inevitably to produce a tax loss … ."

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

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

- ***Background*** — Codification of the economic substance doctrine has been on the legislative agenda many times since early in the first decade of this century, or for the past ten years (for those of us still hung up on Y2K). The move for codification was motivated in part by the insistence of not a few tax practitioners that the economic substance doctrine simply was not actually a legitimate element of the tax doctrine, notwithstanding its application by the courts in many cases over several decades. This argument was based on the assertion that the Supreme Court had never actually applied the economic substance doctrine to deny a taxpayer any tax benefits, ignoring the Supreme Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960), and instead focusing on the Supreme Court's subsequent decisions in *Cottage*

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

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

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

> [W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

- This passage – which sets forth a statement as to what was sufficient for economic substance, but which was subsequently interpreted to be a statement as to what was necessary for economic substance[12] – has led courts to two different formulations of the economic substance doctrine. One, the so-called "conjunctive test" requires that a transaction have *both* (1) economic substance and (2) a non-tax business purpose in order to be respected for tax purposes. See, e.g., *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9 (2009); *Coltec*, *supra*. Under the other formulation, the so called "disjunctive test," represented principally by *IES Industries v. United States,* 253 F.3d 350, 358 (8th Cir. 2001), and *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), a transaction would be respected for tax purposes if it had *either* (1) economic substance and (2) a non-tax business purpose. Yet a third articulation appeared in *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S.

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

1017 (1999), where the court concluded that, that "these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." The courts also have differed with respect to the nature of the non-tax economic benefit a taxpayer is required to establish to demonstrate that a transaction has economic substance. Some courts required a potential economic profit. See, e.g., ***Knetsch v. United States***, 364 U.S. 361 (1960); ***Goldstein v. Commissioner***, 364 F.2d 734 (2d Cir. 1966), ***cert. denied***, 385 U.S. 1005 (1967). Other courts have applied the economic substance doctrine to disallow tax benefits where – even though the taxpayer was exposed to risk and the transaction had a profit potential – compared to the tax benefits, the economic risks and profit potential were insignificant. ***Sheldon v. Commissioner***, 94 T.C. 738 (1990); ***Goldstein***, ***supra***. Yet other courts have asked whether a stated business benefit – for example, cost reduction, as opposed to profit-seeking – of a particular transaction was actually obtained through the transaction in question. See ***Coltec Industries, Inc. v. United States***, 454 F.3d 1340 (Fed. Cir. 2006), ***cert. denied***, 127 S. Ct. 1261 (2007). Finally, notwithstanding that several courts have rejected the bootstrap argument that an improved financial accounting result — derived from tax benefits increasing after-tax profitability — served the valid business purpose requirement, see, e.g., ***American Electric Power, Inc. v. United States***, 136 F. Supp. 2d 762, ***aff'd***, 326 F.3d.737 (6th Cir. 2003); ***Wells Fargo & Company v. United States***, 91 Fed. Cl. 35 (2010), taxpayers continued to press such claims.

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

- ***Conjunctive analysis of objective and subjective prongs*** — One of the most important aspects of new § 7701(o) is that it requires a *conjunctive* analysis under which a transaction has economic substance only if (1) the transaction changes the taxpayer's economic position in a meaningful way apart from Federal income tax effects ***and*** (2) the taxpayer has a substantial business purpose, apart from Federal income tax effects, for entering into such transaction. (The second prong of most versions of the codified economic substance doctrine introduced in earlier Congresses added "and the transaction is a reasonable means of accomplishing such purpose." See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). It is not clear what difference in application was intended by adoption of the different final statutory language.) This conjunctive test resolves the split between the Circuits (and between the Tax Court and certain Circuits) by rejecting the view of those courts that find the economic substance doctrine to have been satisfied if there is either (1) a change in taxpayer's economic position ***or*** (2) a nontax business purpose, see, e.g., ***Rice's Toyota World v. Commissioner***, 752 F.2d 89 (4th Cir. 1985); ***IES Industries, Inc. v. United States***, 253 F.3d 350, 353 (8th Cir. 2001). Section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions. The Staff of the Joint Committee Report indicates that the provision "does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine," and gives as an example the courts' ability "to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits."

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

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

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

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

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

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

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

- ***Penalties, oh what penalties!*** — New §§ 6662(b)(6), in conjunction with new § 6664(c)(2), imposes a *strict liability* 20 percent penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the meaning of new § 7701(o), "or failing to meet the requirements of any similar rule of law." (Does that extend to substance versus form in a SILO? How about business purpose in a purported tax-free reorganization?) The penalty is increased to 40 percent if the taxpayer does not adequately disclose the relevant facts on the original return or an amended return filed before the taxpayer has been contacted for audit — an amended return filed after the initial contact cannot cure original sin. I.R.C. § 6664(i). Because the § 6664(c) "reasonable cause" exception is unavailable, outside (or in-house) analysis and opinions of counsel or other tax advisors will not insulate a taxpayer from the penalty if a transaction is found to lack economic substance. Likewise, new § 6664(d)(2) precludes a reasonable cause defense to imposition of the § 6662A reportable transaction understatement penalty for a transaction that lacks economic substance. (Section 6662A(e)(2) has been amended to provide that the § 6662A penalty with respect to a reportable transaction understatement does not apply to a transaction that lacks economic substance if a 40 percent penalty is imposed under § 6662(i)). A similar no-fault penalty regime applies to excessive erroneous refund claims that are denied on the ground that the transaction on which the refund claim was based lacked economic substance. § 6676(c). However, under the "every dark cloud has a silver lining" maxim, the §§ 6662(b)(6) and 6664(c)(2) penalty regime does not apply to any portion of an underpayment on which the § 6663 fraud penalty is imposed.
- ***Effective date*** — Section 7701(o) and the revised penalty rules applies to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after 3/30/10.

a. **Better than a sharp stick in the eye, but not much better. The IRS is catching conjunctivitis, weighing in on the conjunctive test.** Notice 2010-62, 2010-40 I.R.B. 411 (9/13/10). The IRS indicates that it will rely on relevant case law in applying the two-pronged conjunctive test for economic substance. Thus, both in determining whether a transactions meets both of the requirements of the conjunctive test, the IRS will apply cases under the common law economic substance doctrine to determine whether tax benefits are allowable because a transaction satisfies the economic substance prong of the economic substance doctrine and to determine whether a transaction has a sufficient nontax purpose to satisfy the requirement that the tax benefits of a transaction are not allowable because the taxpayer lacks a business purpose. The IRS adds that it will challenge taxpayers who seek to rely on case law that a transaction will be treated as having economic substance merely because it satisfies either of the tests. The IRS also indicates that it anticipates that the law of economic substance will continue to evolve and that it "does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."

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

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

- *Three step analysis:* (1) First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate. (2) Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate. (3) Third, if an examiner determines that the application of the doctrine may be appropriate, the examiner must make a series of inquiries before seeking approval to apply the doctrine.

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

(1) The transaction is not promoted/developed/administered by tax department or outside advisors;
(2) The transaction is not highly structured;
(3) The transaction contains no unnecessary steps;
(4) The transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives;
(5) The transaction is at arm's length with unrelated third parties;
(6) The transaction creates a meaningful economic change on a present value basis (pre-tax);
(7) The taxpayer's potential for gain or loss is not artificially limited;
(8) The transaction does not accelerate a loss or duplicate a deduction;
(9) The transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
(10) The taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction;
(11) The transaction does not involve a tax-indifferent counter-party that recognizes substantial income;
(12) The transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
(13) The transaction has credible business purpose apart from federal tax benefits;
(14) The transaction has meaningful potential for profit apart from tax benefits;
(15) The transaction has significant risk of loss;
(16) Tax benefit is not artificially generated by the transaction;
(17) The transaction is not pre-packaged.
(18) The transaction is not outside the taxpayer's ordinary business operations.

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

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

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

- The seven required subsequent inquiries:

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

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

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

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

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

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

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

- *Approval Process.* If an examiner completes the inquiries described above and concludes that it is appropriate to seek approval for the application of the economic substance doctrine, the examiner, in consultation with his or her manager and territory manager, should describe the analysis in writing for the appropriate Director of Field Operations, whose approval is required.
- *Penalties Limitation.* Until further guidance is issued, the penalties provided in §§ 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

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

c. **"I'm not sure how important it is to have formal guidance — this is what's supposed to be issued. It sets forth the procedures that exam, counsel, [and] managers need to follow . . . who's the formal guidance supposed to benefit?"** Mark Silverman, 2011 TNT 137-1. Deborah Butler states that taxpayers may not rely on this guidance.

d. **Can this notice be relied upon, or is this just another example of "You [fouled] up – you trusted us"?** Notice 2014-58, 2014-44 I.R.B. 746 (10/9/14), *amplifying* Notice 2010-62, 2010-40 I.R.B. 411 (9/13/10). This notice provides that the term "transaction" generally includes all the factual elements relevant to the expected tax treatment of any plan, with facts and circumstances determining whether a plan's steps are aggregated or disaggregated. The term "similar rule of law" [as described in the § 6662(b)(6) penalty provision] means a rule or doctrine that disallows the tax benefits related to a transaction by applying the same factors and analysis that is required under § 7701(o) for an economic substance analysis even if a different term, e.g., "sham transaction doctrine," is used to describe the rule or doctrine.

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

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

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

- Although the ABA lost in the Supreme Court, *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (American Bar Endowment's income from life insurance policy dividends retained represent profits from the insurance program rather than charitable donations from your members. The court further stated that if the members were given a choice between allowing the American Bar Endowment to retain the dividends and having the dividends refunded to them, then the dividends retained might constitute charitable donations rather than unrelated business income.), it changed its insurance arrangements to achieve the same result by permitting cash refunds to policyholders who claimed them in writing each year, P.L.R. 8725056 (3/25/87).

a. **The Seventh Circuit follows the Reg. § 1.501(c)(6)-1 definition of § 501(c)(6) "business league" in finding that the ABA retirement program was not one.** ABA Retirement Funds v. United States, 759 F.3d 718 (7th Cir. 7/21/14). Specifically, the

Seventh Circuit (Judge Wood) affirmed on the grounds that the non-profit ABA Retirement Funds: (1) did not improve business conditions of the legal profession but instead provided retirement plans to individual lawyers, and (2) engaged in a business ordinarily conducted for profit.

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

2. Vexatious litigation for personal purposes does not serve charitable purposes, as established by multiple IRS requests for information. Although he was entitled to a review of the IRS denial of § 501(c)(3) status – unlike seekers of § 501(c)(4) status – Mr. Huggins lost in the Tax Court. Council for Education v. Commissioner, T.C. Memo. 2013-283 (12/16/13). Following his failure to graduate from the University of California Santa Barbara, between 1993 and 2002 Harold Huggins initiated a series of claims and lawsuits against the University, its Academic Senate (which one of us twice chaired), the California Student Aid Commission, and the Western Association of Schools and Colleges, alleging that the defendants coerced him into withdrawing from UCSB, extorted students loans through grade fraud and intimidation and violated RICO and the False Claims Act. The Tax Court (Special Trial Judge Guy) pointed out that all of these claims were dismissed and that Mr. Huggins was declared by the Federal District Court to be a vexatious litigant. In 2006 Mr. Huggins organized the petitioner as a nonprofit mutual benefit corporation to investigate academic fraud with the specific purpose to investigate and report fraudulent activities relating to student loan programs, advocate for student loan recipients, and enforce Department of Education accreditation standards for all students regardless of race or ethnicity. In 2008, the petitioner sought recognition of the organization as a charitable organization under § 501(c)(3). Petitioner continued to file claims similar to Mr. Huggins' prior actions, and formed a "Special Committee 1868" to gather evidence that former UC Regent Ward Connerly (who was a leading advocate of California's proposition 209 that prohibited race and gender based discrimination in public employment, education, and contracting) was an unregistered foreign agent, abused his position as a Regent and had personal financial interest in matters before the UC Board of Regents and had organized so-called civil rights organizations to deceive California voters. Following multiple administrative inquiries for information regarding petitioner's activities, the IRS denied the claim for exemption. The court affirmed the denial. The court recognized that an organization may qualify for charitable status where in carrying out its primary purpose the organization advocates social or civic changes or presents opinions on controversial issues. The court also observed that the IRS recognizes that organizations that provide legal services or engage in litigation may serve a charitable purpose. However, the court noted that where an individual creates and controls the affairs of an organization without an independent board of directors "there is an obvious opportunity for abuse." The court stated that "[p]rominent among petitioner's shortcomings are the lack of a formal business plan and an independent board of directors to provide operational guidance and oversight." The court further indicated that Mr. Huggins, acting as petitioner's sole officer, director, and employee, did not demonstrate the skills to conduct petitioner's operations to achieve its charitable purpose to further the public good. Indeed, the court indicated that it "would be hard pressed to say that petitioner's operations do not more than incidentally further Mr. Huggins' private interests."

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

4. The IRS continues to have problems with exempt organization issues. Z Street Inc. v. Koskinen, 113 A.F.T.R.2d 2014-2217 (D. D.C. 5/27/14). The District Court (Judge Jackson) refused to dismiss a complaint filed by a pro-Israel nonprofit group seeking declaratory and injunctive relief with respect to the processing of its application for § 501(c)(3) status. The complaint asserted that the IRS had a special policy of intense scrutiny, which it applied to organizations whose activities relate to Israel "and whose positions with respect to Israel contradict the current position of the U.S. Government." The court refused to dismiss this constitutional claim based on the premise that the Israel Special Policy constituted "impermissible viewpoint discrimination on the part of the federal government." Judge Jackson rejected the government's assertions that the action should be dismissed under (1) the Anti-Injunction Act, 26 U.S.C. § 7421, (2) the Declaratory Judgment Act, 28 U.S.C. § 2201, and (3) the doctrine of sovereign immunity.

5. The IRS introduces Form 1023-EZ, a shorter application form to help small charities apply more easily for recognition of tax-exempt status under § 501(c)(3). T.D. 9764, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 79 F.R. 37630 (7/2/14). The Treasury has issue proposed and temporary regulations that permit the IRS to adopt a streamlined application process that eligible organizations may use to apply for recognition of tax-exempt status under § 501(c)(3). The temporary regulations, § 1.508-1T(a)(2)(i), provide that eligible organizations may use Form 1023-EZ, ''Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,'' to notify the IRS of their applications for tax-exempt status. The regulations are effective on 7/1/14.

- According to an announcement issued by the IRS, "[t]he change will allow the IRS to speed the approval process for smaller groups and free up resources to review applications from larger, more complex organizations while reducing the application backlog. Currently, the IRS has more than 60,000 501(c)(3) applications in its backlog, with many of them pending for nine months." IR 2014-77, 2014 TNT 127-13 (7/1/14).

a. The IRS provides guidance on the new streamlined application process for recognition of tax-exempt status under § 501(c)(3). Rev. Proc. 2014-40, 2014-30 I.R.B. 229 (7/1/14). This revenue procedure sets forth the procedures for applying for recognition of (and for issuing determination letters on) an organization's tax-exempt status under § 501(c)(3) using Form 1023-EZ. Generally, an organization can submit Form 1023-EZ (rather than Form 1023) if it is a U.S. organization with both assets valued at $250,000 or less and annual gross receipts of $50,000 or less. The revenue procedure sets forth a lengthy list of organizations that cannot submit Form 1023-EZ, including churches, schools, colleges, and hospitals. Form 1023-EZ must be submitted electronically and the user fee for doing so is $400, as opposed to the $850 user fee charged to organizations submitting Form 1023 that have actual or anticipated average annual gross receipts exceeding $10,000. Organizations that submit Form 1023-EZ need not separately request a determination that they need not file an annual return on Form 990 or Form 990-EZ if they claim a filing exemption solely on the basis that their gross receipts are normally $50,000 or less. The revenue procedure is effective 7/1/14.

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

2217 (D. D.C. 5/27/14), in December 2010 because the cases were "grounded on factually different subjects."

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

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

  -establish written financial assistance and emergency medical care policies;

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

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

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

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

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

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

B. Charitable Giving

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

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

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

- As 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 reconsidered the whole case in light of the Fifth Circuit decision and increased the allowable deduction by only $65,415, from $1,792,301 to $1,857,716. Whitehouse Hotel Limited Partnership v. Commissioner, 139 T.C. 304 (10/23/12). On remand, Judge Halpern elaborated at length on the proper valuation method to be used to value the building under the "before and after" method, and once again accepted the IRS's argument that the value of the property should be determined using a comparable-sales method. The comparable-sales method applied by Judge Halpern was based on the sales of buildings suitable for conversion into hotels based primarily on local sales data, rejecting the taxpayer's argument that non-local sales data should be taken into account. He again rejected both the taxpayer's reproduction-cost method and income method to valuation. Judge Halpern explained that "[t]he reproduction cost of an historic building usually bears little relationship to its present economic value. Such cost is usually far in excess of the cost of construction of a similarly sized modern structure, and may reflect the price of materials and workmanship that are no longer readily available." Because reconstruction of the Maison Blanche Building, if destroyed, would not have been a reasonable business venture, there was no probative correlation between the taxpayer's expert's estimate of the reproduction cost of the Maison Blanche Building and the fair market value of the property. Judge Halpern rejected the income valuation method because in this case, where there was no ongoing business, it was based on too many contingencies, was inadequately developed, and thus was too speculative, particularly where the value could be established by comparable sales. He did not reject the income method of valuation as a matter of law. He stated: "We have no difficulty with the process. Where we have difficulty is with petitioner's call to trust on their face [the taxpayer's expert's] judgments as to values to be input to his model." Judge Halpern also again found that the easement conveyance did not deprive the partnership or any subsequent owner of the ability to add stories to the top of the Kress Building or blocking views of the Maison Blanche facade. However, in light of the Fifth Circuit's directive, Judge Halpern determined the value of the facade conservation easement based on the before- and after-restriction values of the combined Maison Blanche and Kress Building property. He concluded that the value of the easement was approximately $1.86 million, rather than $1.79 million as determined in his first opinion. Responding to the Fifth Circuit's determination that he had misapprehended the properties highest and best use, Judge Halpern reasoned that "although the highest and best use of property may determine a ceiling on how much a willing buyer would pay for the property, it does not necessarily determine a floor on how little a willing seller would accept. . . . [T]he hypothetical willing buyer and the hypothetical willing seller who populate our standard definition of fair market value will not invariably conclude their negotiation over price at a price reflecting the value of the property at its highest and best use." He turned to auction price theory to conclude that in determining the fair market value of the property, which is the relevant benchmark, "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 easement exceeded 400 percent of the actual value, i.e., 401 percent, and the § 6662(h) gross valuation misstatement penalty applied. The § 6664(c) reasonable cause and good-faith exceptions did not apply, because Whitehouse failed to make a good-faith investigation of the value of the easement and did not reasonably rely on an appraisal.

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

> We are particularly persuaded by Whitehouse's argument that the Commissioner, the Commissioner's expert, and the tax court all reached different conclusions. The Commissioner originally permitted only $1.15 million as a deduction. [The Commissioner's expert] valued the easement as worthless We share the tax court's and the Commissioner's skepticism of the dramatic appreciation of value between the roughly $8,000,000 purchase price of the Maison Blanche shell and the [taxpayer's expert's] appraisal's $96,000,000 valuation. What the taxpayer reasonably considered, though, even if not sustained by the tax court, is that its contract to transform the building into a Ritz-Carlton hotel had value. As we were in our 2010 opinion, we are skeptical of the tax court's conclusion that following the advice of accountants and tax professionals was insufficient to meet the requirements of the good faith defense, especially in regard to such a complex task that involves so many uncertainties.
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> . . . for the general reasonable cause exception, we review the "totality of the facts and circumstances." Whitehouse obtained a second appraisal as a "check" against the first one. [A Whitehouse partner] testified and presented the 1997 Form 1065 indicating it had been prepared by Whitehouse's financial auditors. Obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally-prepared tax return is sufficient to show a good faith investigation as required by law. *See* I.R.C. § 6664(c)(3)(B). The tax court's enforcement of the gross undervaluation penalty was clearly erroneous. (citations omitted)

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

a. **Plea for a mulligan is rejected**! Kaufman v. Commissioner, 136 T.C. 294 (4/4/11). On the taxpayers' motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a "'prior claim' to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation," and 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. Shulman, 687 F.3d 21 (1st Cir. 7/19/12). The First Circuit, however, in an opinion by Judge Boudin, disagreed with the Tax Court, holding that a mortgagee's right to satisfy the mortgage lien before the donee of the conservation easement is entitled to any amount from the sales or condemnation proceeds from the property does not necessarily defeat the charitable contribution deduction. Judge Boudin's opinion noted that "the Kaufmans had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds – tax liens being superior to most prior claims, 1 Powell on Real Property § 10B.06[6] (Michael Allan Wolf ed., Matthew Bender & Co. 2012), including in Massachusetts the claims of the mortgage holder."[13] 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

[13] 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.

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).

- 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.
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> Under the *Standards and Criteria*, property owners of South End buildings have an obligation to retain and repair the original steps, stairs, railings, balustrades, balconies, entryways, transoms, sidelights, exterior walls, windows, roofs, and front-yard fences (along with certain "other features"); and, when the damaged elements are beyond repair, property owners may only replace them with elements that look like the originals. Given these pre-existing legal obligations the Tax Court might well find on remand that the Kaufmans' easement was worth little or nothing.

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

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

3. **Mining is not the highest and best use for land that no one actually wants to mine.** Esgar Corp. v. Commissioner, T.C. Memo. 2012-35 (2/6/12). The taxpayers granted conservation easements in certain land that was zoned irrigated, agricultural, and which had historically been used as irrigated and unirrigated farmland. The land was not permitted for

any mining, but absent the donations it was likely that the necessary permits to mine (gravel) could have been obtained. The terms of the conservation easements provided the donee organization perpetual rights to preserve the natural and open space conditions and protect the wildlife, ecological, and environmental values and water quality characteristics of the property. The conservation easements specifically prohibited the mining or extraction of sand, gravel, rock, or any other mineral. The taxpayers valued the easement donation under the "before and after method," treating the highest and best use before the donation as gravel mining. The Tax Court (Judge Wherry) held that the before highest and best use was agricultural, not mining.

> Where . . . an asserted highest and best use differs from current use, the use must be reasonably probable and have real market value. . . . "Any suggested use higher than current use requires both 'closeness in time' and 'reasonable probability'". *Hilborn v. Commissioner*, [85 T.C. 677, 689 (1985)]. Any proposed uses that "depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable" are to be excluded from consideration. *Olson v. United States*, 292 U.S. 246, 257 (1934).
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> Where the asserted highest and best use of property is the extraction of minerals, the presence of the mineral in a commercially exploitable amount and the existence of a market "that would justify its extraction in the reasonably foreseeable future" must be shown. *United States v. 69.1 Acres of Land*, [942 F.2d 290, 292 (4th Cir. 1991)]. "There must be some objective support for the future demand, including volume and duration. Mere physical adaptability to a use does not establish a market."

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

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

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

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

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

c. The mortgage subordination provision is "a bright line requirement." "The remote future provision cannot be reasonably read as modifying the strict mortgage subordination requirement." Mitchell v. Commissioner, __ F.3d___, 2015 WL 64927 (10th Cir. 1/6/15). In an opinion by Judge McHugh, the Tenth Circuit affirmed the Tax Court's decision. First, the court held that Reg. § 1.170A-14(g), requiring subordination of any mortgage as a condition of eligibility for a deduction, was valid. Second, it held that the taxpayer's arguments that she was entitled to the deduction because (1) Reg. § 1.170A-14(g) does not impose an explicit time-frame for compliance, and (2) despite the failure to subordinate the mortgage at the time of conveyance, the deed contained sufficient safeguards to protect the conservation purpose in perpetuity, both were contrary to the "plain language" of Reg. § 1.170A-14(g). Finally, the court held that the IRS "is entitled to demand strict compliance with the mortgage subordination provision, irrespective of the likelihood of foreclosure." The court rejected the taxpayer's argument that Reg. § 1.170.A-14(g)(3), which provides that a deduction will not be disallowed "merely" because the interest that passes to the donee organization may be defeated by the happening of some future event "if on the date of the gift it appears that the possibility that such . . . event will occur is so remote as to be negligible," acts as an exception to the mortgage subordination provision. Finally, citing *Chase Bank USA, N.A. v. McCoy*, 562 U.S. 195, ___, 131 S. Ct. 871, 880-81 (2011), the court reasoned as follows.

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

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

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

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

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

b. The "plain language of the Code" sinks the taxpayers' deduction, and a "savings clause" isn't a life preserver. Belk v. Commissioner, 774 F.3d 221, 114 A.F.T.R.2d 2014-6952 (4th Cir. 12/16/14). In an opinion by Judge Motz, the Fourth Circuit affirmed the Tax Court's disallowance of the deduction. The court held that the plain language of § 170(h)(2)(C), which "provides that a 'qualified property interest' includes 'a restriction (granted in perpetuity) on the use which may be made of *the real property*' (emphasis supplied by the court), "makes clear that a perpetual use restriction must attach to a defined parcel of real property rather than simply *some* or *any* (or interchangeable parcels of) real property." (Emphasis supplied by the court.) Because the taxpayers had the right to remove land from that defined parcel and substitute other land, the easement failed to qualify because the real property was not subject to a use restriction in perpetuity. Furthermore, allowing a deduction in these circumstances, where the borders of an easement could shift, would enable the taxpayers to bypass the requirement of Reg. § 1.170A-14(g)(5)(i) that the donor of a conservation easement make available to the donee "documentation sufficient to establish the condition of the property." Finally, the court rejected the taxpayers' argument that the deduction was preserved by a savings clause in the deed that the donee "shall have no right or power to agree to any amendments . . . that would result in this Conservation Easement failing to qualify . . . as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations." Relying on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the court held the savings clause to be ineffective: "If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt." Thus, the court declined to use the savings clause to rewrite the easement in response to its holding.

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

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

a. Ditto! Reisner v. Commissioner, T.C. Memo. 2014-230 (11/6/14). The Tax Court (Judge Gale) followed *Chandler* regarding the elimination (by § 6664(c)(3))of the "reasonable cause" exception to a 40 percent gross valuation misstatement penalty (§ 6662(h)(1)) for a claimed carried-over charitable contribution deduction to 2006 with respect to a contribution of a valueless facade easement in 2004. Reg. § 1.6662-5(c) "provides that the gross valuation misstatement penalty applies to any portion of an underpayment for a year to which a deduction is carried that is attributable to a gross valuation misstatement for the year in which the carryback or carryover of the deduction arises. Thus, by its terms, the regulation characterizes the penalty-bearing portion of the underpayment in the carryover or carryback year as 'attributable to' the gross valuation misstatement in the originating year."

8. This throws buckets and buckets of ice water on claims for charitable contribution deductions for façade easements in historic districts. Scheidelman v. Commissioner, 755 F.3d 148 (2d Cir. 6/18/14), ***aff'g*** T.C. Memo. 2013-18. In a per curiam opinion by Judge Newman, the Second Circuit affirmed the Tax Court's decision denying the taxpayer's claimed deduction for contribution of an historic facade conservation easement to the National Architectural Trust on the ground that the contribution did not result in any diminution in the value of the property. The burdened property was in the Fort Greene Historic District, which is designated (1) a "registered historic district" by the Secretary of the Interior through the National Park Service, pursuant to § 47(c)(3)(B); and (2) a historic district by New York City's Landmarks Preservation Commission. In New York City it is unlawful to alter, reconstruct, or demolish a building in a historic district without the prior consent of the LPC. The Court noted:

> [N]either the Tax Court nor any Circuit Court of Appeals has held that the grant of a conservation easement effects a per se reduction in the fair market value. To

> the contrary, the regulations provide that an easement that has no material effect on the obligations of the property owner or the uses to which the property may be put "may have no material effect on the value of the property." Treas. Reg. § 1.170A-14(h)(3)(ii). And sometimes an easement "may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable."

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

9. Contribution of facade conservation easements to facilitate zoning changes and development approval reduces the value of the contribution—and if you claim you got nothing in return, you get no deduction whatsoever. Seventeen Seventy Sherman Street, LLC v. Commissioner, T.C. Memo. 2014-124 (6/19/14). The taxpayer contributed both exterior and interior facade conservation easements restricting the use of the burdened historic property, which was listed on a National Register of Historic Properties, to a qualified donee. Because the property was a designated landmark, proposed structural changes or material renovations to its exterior were subject to the approval of the Denver Landmark Preservation Commission. However, designation as a landmark did not obligate property owners to rehabilitate deteriorating structures, did not prohibit building demolition, and did not protect the interior of the building. Thus, the conservation easement provided stronger protections, such as building monitoring and prohibition of demolition, than designation as a landmark. The Tax Court (Judge Marvel) found that the conservation easements were granted in consideration of the City of Denver granting zoning changes and variances and approving a development plan for the property, and denied the deduction in its entirety—even though the IRS would have allowed a $400,000 deduction, not the $7,150,000 deduction claimed by the taxpayer. The taxpayer had not reported the receipt of any consideration for the contribution and did not treat it as a bargain sale. Accordingly, Judge Marvel reasoned that "when a taxpayer grants a conservation easement as part of a quid pro quo transaction and fails to identify or value all of the consideration received in the transaction, the taxpayer is not entitled to any charitable contribution deduction with respect to the grant of the conservation easement because he has failed to comply with section 170 and the regulations thereunder." Because the taxpayer "failed to value all of the consideration ... received in the quid pro quo exchange," the court did not reach a conclusion on the value of the interior and exterior easements. Although the § 6662(h) gross valuation misstatement penalty asserted by the IRS was not upheld, because the IRS failed to establish that the value of the conservation easements claimed on the return (i.e., $7,150,000) exceeded 400 percent of the correct value of the easements, a § 6662 negligence penalty was sustained, because the taxpayer did not follow its advisor's advice to reduce the amount of the contribution to reflect the value of the consideration it received.

10. Sometimes you see the disregarded entity, sometimes you don't. RERI Holdings I, LLC v. Commissioner, 143 T.C. No. 3 (8/11/14). RERI Holdings I, LLC contributed a successor membership interest in a single member LLC—a disregarded entity under the "check-the-box" regulations—to a university under a condition that the University not sell the property for two years but would sell it after two years. RERI Holdings valued the contribution based on an appraisal of the value of a hypothetical remainder interest in the disregarded LLC's sole asset, real property subject to a triple net lease. The Tax Court (Judge Halpern) denied the IRS's motion for summary judgment that: (1) the § 7520 tables for valuing remainder interests were not applied correctly to the valuation of the contribution and (2) the appraisal was not a "qualified appraisal" as defined in Reg. § 1.170A-13(c)(3). The IRS argued that it was improper to appraise a hypothetical remainder interest in the underlying real property rather than the LLC interest that was, in fact, donated to the university, taking the position that, assuming the § 7520 tables were applicable, the § 7520 remainder interest factor should have been applied to the fair market value of the contributed LLC. The court agreed with IRS that under the rationale of *Pierre v. Commissioner*, 133 T.C. 24 (2009), a disregarded entity is not disregarded in determining value of the contributed property, but denied the IRS's motion for summary judgment on the ground that the value of the sole asset of an LLC might serve as an acceptable substitute for the LLC's value, which was an issue that could not be resolved on summary judgment. The IRS also argued that Reg. § 1.7520-3(b)(2)(iii) precluded application of the § 7520 tables to determine the value of the LLC, because the holder of the LLC interest did not "'enjoy the same protections as would be afforded ... to a trust remainderman.'" The IRS asserted that the LLC interest could be devalued by depreciation of the real property, its sale, or additional or unpaid mortgage indebtedness, and thus the preservation and protection requirements of Reg. § 1.7520-3(b)(2)(iii) precluded application of the § 7520 tables. The IRS also argued that because of the two-year hold-sell requirement, the property was a restricted beneficial interest within the meaning of Reg. § 1.7520-3(b)(1)(ii) to which the § 7520 tables cannot be applied. The court again held that there were disputed material facts that affected whether the "preservation and protection" requirements in the § 7520 regulations had been met or whether the two-year hold-sell restriction was a "meaningful restriction" that would disqualify use of the § 7520 tables. Regarding the qualified appraisal issue, the court held that the appraisal of the remainder interest in the real property instead of the LLC did not automatically disqualify the appraisal. Although the appraisal did not include the hold-sell requirement, it did not omit any restriction that could have adversely impacted the value of the contributed property. While other aspects of the lease may have affected the accuracy of the appraisal, it was still "qualified." Finally, failure to discuss mortgages, depreciation of the property, or a lessee's rights to remove its property, while possibly resulting in an erroneous valuation of the donated property, are not items that would result in the appraisal not constituting a qualified appraisal under the regulations.

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

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

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

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. The Tax Court refused to accept an accrual-method taxpayer's year 2000 net operating loss, which the Justice Department had accepted for sentencing purposes in a tax fraud criminal prosecution that resulted in probation for a taxpayer with a prior bank fraud conviction for which he spent 20 months in prison. Seiffert v. Commissioner, T.C. Memo. 2014-4 (1/9/14). The taxpayer used the accrual method of accounting to offset wage income with purported bad debts but the only "proof" of the bad debts was a purported NOL which the Justice Department accepted for criminal sentencing purposes. In addition, the taxpayer failed to report 1099 income for the years in question. The Tax Court (Judge Kroupa) held that the criminal plea agreement did not establish the NOL for civil tax purposes, and that no collateral estoppel resulted from the government's acceptance of the plea agreement. Judge Kroupa concluded that the statute of limitations had not expired for the 1996-2001 years in question because the taxpayer filed fraudulent returns for each of those years based upon her finding several badges of fraud (including understatement of income, inadequate and incomplete records, failure to cooperate, and inconsistent explanations and incredible testimony), and upheld the Commissioner's determinations including the fraud penalty under § 6653.

a. Motion for reconsideration denied. Seiffert v. Commissioner, T.C. Memo. 2014-61 (4/7/14). The Tax Court (Judge Kroupa) denied motions for reconsideration and for revision of the decision at T.C. Memo. 2014-4 because she concluded that (1) collateral estoppel did not establish the NOL "because it was not an essential element of the criminal conviction to which the plea agreement related"; and (2) the plea agreement [with respect to the NOL] did not constitute "a factual admission" by the government.

2. Is this Circuit split worth a look by the Supremes, or is it just not political enough to grab their attention? Carlson v. United States, 754 F.3d 1223 (11th Cir. 6/13/14). The Court of Appeals for the Eleventh Circuit held that the government's burden of proof in asserting a § 6701 penalty for aiding and abetting understatement of tax liability is "clear and convincing evidence," not merely a "preponderance of the evidence." Both the Second and Eighth Circuits have held that the government's burden of proof in asserting a § 6701 penalty is a "preponderance of the evidence." *Barr v. United States*, 67 F.3d 469 (2d Cir. 1995); *Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991).

3. Instructions on how to rat yourself out. Rev. Proc. 2014-15, 2014-5 I.R.B. 456 (1/23/14). This revenue procedure updates Rev. Proc. 2012-51, 2012-51 I.R.B. 719, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position.

4. Does the Tax Court think it has jurisdiction? As long as the statute doesn't make clear that it doesn't, it sure does. Corbalis v. Commissioner, 142 T.C. 46 (1/27/14). Judge Cohen held that the IRS's denial of a request to suspend interest under § 6404(g) is subject to review by the Tax Court under § 6404(h). Furthermore, Letters 3477 sent to the taxpayer by the IRS were final determinations for purposes of § 6404(h) even though the taxpayer' concurrent claims for abatement of interest under § 6404(e) were still pending.

5. The Commissioner "♫♪gets Wherry and sick of tryin'♫♪" because he could not prove by clear and convincing evidence that taxpayer's underpayments were

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attributable to fraud because he counted more factors weighing against fraud than factors weighing in favor of fraud. Carreon v. Commissioner, T.C. Memo. 2014-6 (1/9/14). As the result of an "agent-principal" scheme, taxpayer underreported income for 2005 and 2006 by $355,000 and $101,000, respectively, by transferring those amounts to various so-called "trusts." The Tax Court (Judge Wherry) held that taxpayers' reliance on the promoter of this scheme, while not reasonable, mitigated "slightly against a finding of civil fraud." Inadequate maintenance of records weighed slightly in favor of a finding of fraud, etc. Judge Wherry found three factors in favor of fraud, one neutral, and six factors against fraud, so the Commissioner failed to carry "his substantial burden of proving by clear and convincing evidence that [taxpayer] committed fraud." Therefore, the 75 percent civil fraud penalty under § 6663 was not upheld.

6. **To collect § 6672 trust fund penalty taxes, the IRS must prove that it provided notice to the taxpayer as required by § 6672(b); it cannot rely on the presumption of regularity.** United States v. Thomas, 113 A.F.T.R.2d 2014-1459 (N.D. Fla. 3/20/14). Section 6672(b) provides that, before the IRS can impose a § 6672 trust fund recovery penalty, it must notify the taxpayer in writing by mail or in person that the taxpayer will be subject to an assessment of the penalty. According to the Internal Revenue Manual, the IRS complies with this requirement by hand delivering or sending by certified mail a Letter 1153 to the taxpayer. In this case, the government claimed to have mailed a Letter 1153 to the taxpayer on October 15, 2012. To prove this, the government submitted "a copy of the electronically-maintained Form 1153 letter and a printout of the history log from the IRS' Automated Trust Fund Recovery . . . system." The government also submitted a declaration from a Revenue Officer "stating it is the IRS' standard practice to send a 1153 letter to a taxpayer by certified mail before assessing trust fund recovery penalties against him." The court agreed with the taxpayer that, because the government was able to produce only an unsigned, undated copy of the Letter 1153 and produced no receipt demonstrating that it had been sent by certified mail, the government had failed to meet its burden of proving that the required notice had been sent. The court noted that a sister court had not applied the presumption of regularity in a prior decision involving nearly identical facts and that its decision had been affirmed by the Eleventh Circuit. See *Bonaventura v. United States*, 105 A.F.T.R.2d 2010-1039 (N.D. Ga. 2009), *aff'd per curiam*, 428 Fed. Appx. 916 (11th Cir. 2011). Accordingly, the court granted the taxpayer's motion for summary judgment. The court observed that the period of limitations on assessment of the penalty tax had expired.

7. **A Knight's estate might be able to avoid late payment penalties by establishing reasonable cause based on erroneous advice from an attorney.** Estate of John R.H. Thouron v. United States, 752 F.3d 311 (3d Cir. 5/13/14). John R.H. Thouron, KBE,[14] the widower of Esther du Pont Thouron, died leaving a substantial estate. The estate tax return was due on 11/6/07. The estate timely filed a request for an automatic 6-month extension of time to file and made a payment of $6.5 million, less than the $20 million ultimately owed. The estate did not request an extension of time to pay, allegedly because of advice from its tax attorney concerning the estate's ability to elect under § 6166 to pay a portion of its estate tax liability in installments over several years. The estate filed its return in May 2008 and at that time requested an extension of time to pay. The estate did not make the election under § 6166 because it had concluded that it did not qualify. The IRS denied as untimely the request for an extension of time to pay and imposed a late payment penalty under § 6651(a)(2) of $999,072 plus interest. The estate contested the penalty on the basis that § 6651(a)(2) grants relief from the penalty when the failure to pay is "due to reasonable cause and not due to willful neglect." The District Court granted summary judgment to the government, but the Third Circuit, in an opinion by Judge

[14] The letters KBE are used to designate a person's status as Knight Commander, Order of the British Empire.

Ambro, reversed and remanded. The court relied on Reg. § 301.6651-1(c)(1) for the proposition that a taxpayer demonstrates reasonable cause by establishing that "he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date." Judge Ambro examined the Supreme Court's opinion in ***United States v. Boyle***, 469 U.S. 241 (1985) and concluded that, although ***Boyle*** addresses establishing reasonable cause for failure to timely file a return, its holding also applies to establishing reasonable cause for failure to timely pay tax. In ***Boyle***, Judge Ambro stated, the Supreme Court identified three distinct categories of cases: (1) those in which "a taxpayer relies on an agent for the ministerial task of filing or paying," (2) those in which "'in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the adviser erroneously told him was available,'" and (3) those in which "'an accountant or attorney advises a taxpayer on a matter of tax law.'" Judge Ambro concluded that the facts of ***Boyle*** fell into the first category and that the Supreme Court had not addressed the remaining two categories. Thus, according to Judge Ambro, a taxpayer cannot establish reasonable cause by relying on an agent for the ministerial act of filing or paying, as in ***Boyle***, but "a taxpayer's reliance on the advice of a tax expert may be reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline." Because there was a genuine issue of material fact as to the estate's reliance on a tax expert's advice, the Third Circuit reversed and remanded for further proceedings.

- The estate has brought legal action against its tax advisers. ***Estate of John R.H. Thouron v. Cecil Smith & Associates, PC***, 2013 WL 56090 (E.D. Pa. 1/3/13).

8. Well, well; a "marriage" of corporations isn't the same as a marriage between individual "persons" for purposes of this Code section, it's better. <u>Wells Fargo & Co. v. United States</u>, 117 Fed. Cl. 30 (6/27/14). Section 6621(d) allows "global netting" on interest rates for tax overpayments and tax underpayments by the "same taxpayer" to address the disparity between the higher interest rate imposed on tax underpayments and the lower interest rate applied when the government pays a refund on tax overpayments. On a motion for summary judgment, the Court of Federal Claims (Judge Firestone) held that the term "same taxpayer" includes both predecessors of the surviving corporation in a statutory merger. Section 6621(d) allows interest netting regardless of whether the overlapping overpayments and underpayments involve corporations that were separate prior to the merger; following a merger, the entities become one and the same as a matter of law and thus become the "same" for purposes of interest netting. The court rejected the government's argument that § 6621(d) netting applies only when the overpayment and underpayment were made by the taxpayer with the same TIN at the time of the payments.

9. To establish a good faith reliance penalty defense, you have to prove that your tax advisor knew what he was doing. <u>Wright v. Commissioner</u>, T.C. Memo. 2014-175 (8/28/14). The taxpayers, through a partnership, claimed a $3,000,000 loss generated through transactions involving a series of euro put and call options, with two of the put options being donated to a charity. The loss depended on the options being marked-to-market under § 1256(c) as a foreign currency contract as defined in § 1256(g)(2). In an earlier proceeding, ***Wright v. Commissioner***, T.C. Memo. 2011-292, the Tax Court determined that the options were not foreign currency contracts. The issue in the instant proceeding was whether to sustain a § 6662(a) accuracy-related penalty. The taxpayers argued that they relied reasonably and in good faith on a tax-advisor law firm's tax opinion stating that the loss was "'more likely than not' to be 'upheld by a court if challenged by the IRS and fully litigated on the merits.'" The court (Judge Foley) rejected their good faith reliance defense on two grounds. First, the opinion stated that the law firm relied upon certain "representations and advice" provided to it by the partnership and that the opinion could not be relied on if such representations and advice were "'inaccurate in any material respect, or prove not to be authentic,'" and a letter to the partnership transmitting the tax opinion stated that "'[w]hile we are furnishing you the opinion letter, please be advised that the opinion letter may not be relied upon (and is not otherwise released) unless and until we have the Investor Representations fully executed by you.'" Although the law firm reviewed a copy of unsigned investor representations, the executed investor representations were never delivered. Second, the law firm did not have significant experience relating to the taxation of foreign currency options. The lawyer who prepared the opinion "lacked the requisite tax expertise to justify petitioners' reliance." The "law firm based its opinion that a foreign currency option constitutes a foreign currency contract primarily on its interpretation of section 1256. This interpretation, however, was not well reasoned and ignored the plain language of the statute." Thus, their reliance was "unreasonable."

B. Discovery: Summonses and FOIA

1. You can't hide your foreign bank account records behind the Fifth Amendment. M.H. v. United States, 648 F.3d 1067 (9th Cir. 8/19/11), *cert. denied* 133 S. Ct. 26 (6/25/12). M.H. was the target of a grand jury investigation seeking to determine whether he used secret Swiss bank accounts to evade paying federal taxes. The District Court granted a motion to compel his compliance with a grand jury subpoena *duces tecum* demanding that he produce certain records related to his foreign bank accounts. The District Court declined to condition its order compelling production upon a grant of limited immunity and, pursuant to the recalcitrant witness statute, 28 U.S.C. § 1826, held him in contempt for refusing to comply. The Ninth Circuit upheld the District Court order. The Court of Appeals held that "[b]ecause the records sought through the subpoena fall under the Required Records Doctrine, the Fifth Amendment privilege against self-incrimination is inapplicable, and M.H. may not invoke it to resist compliance with the subpoena's command." The records were required to be kept pursuant to the predecessor of 31 C.F.R. § 1010.420.

- The opinion stated:

> There is nothing inherently illegal about having or being a beneficiary of an offshore foreign banking account. According to the Government, § 1010.420 applies to "hundreds of thousands of foreign bank accounts—over half a million in 2009." Nothing about having a foreign bank account on its own suggests a person is engaged in illegal activity. That fact distinguishes this case from *Marchetti* and *Grosso*, where the activity being regulated—gambling—was almost universally illegal, so that paying a tax on gambling wagers necessarily implicated a person in criminal activity. Admitting to having a foreign bank account carries no such risk. That the information contained in the required record may ultimately lead to criminal charges does not convert an essentially regulatory regulation into a criminal one.

a. When the government asks, ya gotta pony up the name(s) on your foreign bank accounts, the account numbers, the name and address of the banks, the type of account, and the maximum value of each such account during each year. In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011, 691 F.3d 903 (7th Cir. 8/27/12), *cert. denied*, 133 S. Ct. 2338 (5/13/13). In an opinion by Judge Bauer, the Seventh Circuit held that the compulsory production of foreign bank account records required to be maintained under the Bank Secrecy Act of 1970 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 the taxpayer's bank records issued in connection with an investigation into whether he used secret offshore bank accounts to evade his federal income taxes was enforced.

b. A third decision going the same way. In re: Grand Jury Subpoena, 696 F.3d 428 (5th Cir. 9/21/12). The Fifth Circuit (Judge Dennis), in reversing a district court, declined to create a circuit split and held that the required records doctrine applied; the individual was required to produce foreign bank records subpoenaed in the IRS's investigation into whether he used secret Swiss bank accounts [with UBS] to evade his federal income taxes. The court's reasoning was that the Bank Secrecy Act's record-keeping requirement is "essentially regulatory," the records sought are of a kind "customarily kept" by account holders, and the records have assumed "public aspects"; this is so even though one purpose of the BSA was to aid law enforcement officials in pursuing criminal investigations.

c. The Second Circuit held that owners of secret offshore foreign bank accounts are not "inherently suspect" of tax evasion or of anything else illegal. In re: Grand Jury Subpoena Dated February 2, 2012, 741 F.3d 339 (2d Cir. 12/19/13). The Second Circuit (Judge Wesley) held that the required records exception to the Fifth Amendment applied, and that production of foreign bank records was required. Judge Wesley stated:

> The record keeping regulation at issue here, 31 C.F.R. section 1010.420, targets those engaged in the lawful activity of owning a foreign bank account. "There is nothing inherently illegal about having or being a beneficiary of an offshore foreign bank account." M.H., 648 F.3d at 1074. Doe's protestations notwithstanding, owners of these accounts are not "inherently suspect" and the statute is "essentially regulatory."
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> Doe's argument that the statute is criminally focused has some force. The BSA [Bank Secrecy Act] declares that its purpose is "to require certain reports or records where they have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism." 31 U.S.C. section 5311. It does list "criminal investigations" first, but this multifaceted statute clearly contributes to civil and intelligence efforts wholly unrelated to any criminal purpose.
>
> Although portions of the statute's legislative history support Doe's characterization of the BSA as focused on criminal activity, "[t]he Supreme Court has already considered and rejected these arguments as they relate to the BSA generally." M.H., 648 F.3d at 1074 (citing Cal. Bankers' Ass'n v. Shultz, 416 U.S. 21, 76-77 (1974)). Moreover, "the question is not whether Congress was subjectively concerned about crime when enacting the BSA's recordkeeping and reporting provisions, but rather whether these requirements apply exclusively or almost exclusively to people engaged in criminal activity." Grand Jury Proceedings, No. 4-10, 707 F.3d at 1271; accord Grand Jury Subpoena, 696 F.3d at 434. Looking beyond "Congressional subjective intent"—if there could be such a thing—the BSA has considerable regulatory utility outside of the criminal justice context.
>
> The question becomes whether a statute with mixed criminal and civil purposes can be "essentially regulatory" with respect to the required records exception. We agree with our sister circuits: the fact "[t]hat a statute relates both to criminal law and to civil regulatory matters does not strip the statute of its status as 'essentially regulatory.'" Grand Jury Proceedings, No. 4-10, 707 F.3d at 1270. Because people owning foreign bank accounts are not inherently guilty of criminal activity, the BSA's applicable recordkeeping requirement, designed to facilitate "criminal, tax, or regulatory investigations or proceedings, or [] the conduct of intelligence or counterintelligence activities," 31 U.S.C. section 5311, is still essentially regulatory. (footnote omitted)

- These were records that were routinely maintained and made available to government agents upon request by those German Jews who held secret accounts in Swiss banks during the 1930s and 1940s.

d. No circuit conflicts yet; the fifth case was from the Fourth Circuit. United States v. Under Seal, 737 F.3d 330 (4th Cir. 12/13/13). The Fourth Circuit (Judge Agee) agreed with the other circuits that have dealt with this issue, and held that the required records doctrine overrode the Fifth Amendment privilege against self-incrimination of a couple who held an account (successively) in two Swiss private banks.

2. Will the Supreme Court tell us how a witness can meet his burden in demonstrating that an IRS subpoena was issued for an improper purpose when the district court permitted him neither discovery nor an evidentiary hearing? United States v. Clarke, 517 Fed. Appx. 689 (11th Cir. 4/18/13), *vacating and remanding per curiam* 111 A.F.T.R.2d

2013-1697 (S.D. Fla. 4/16/12), *cert. granted*, 134 S. Ct. 895 (1/10/14). Michael Clarke, the Chief Financial Officer of Beekman Vista, Inc., was issued an IRS summons with respect to the examination of Dynamo Holdings Limited Partnership ("DHLP") for its 2005, 2006, and 2007 years. The summons was issued on 10/28/10, which was prior to the issuance to DHLP by the IRS of a Notice of Final Partnership Administrative Adjustment ("FPAA") on 12/28/10 and prior to the filing by DHLP of a Tax Court petition on 2/1/11. The district court heard argument on Clarke's motion to dismiss the summons but declined to grant discovery or an evidentiary hearing. The district court enforced the summons when it found Clarke's answer to the summons to be inadequate to overcome the apparent regularity of the summons proceeding under the holding in *United States v. Powell*, 379 U.S. 48 (1964). That answer contained the allegation that the summons was issued because the government was "displeased that DHLP declined to extend its statute of limitations period," which the district court dismissed as "mere conjecture unsupported by evidence." The Eleventh Circuit agreed with the district court that the *Powell* requirements had been met by the IRS with its prima facie showing of the four required elements:

> To obtain enforcement of a summons, the IRS must make a four-part prima facie showing that (1) "the investigation will be conducted pursuant to a legitimate purpose," (2) "the inquiry may be relevant to the purpose," (3) "the information sought is not already within the Commissioner's possession," and (4) "the administrative steps required by the Code have been followed." *United States v. Powell*, 379 U.S. 48, 57-58, 85 S. Ct. 248, 13 L. Ed. 2d 112 (1964); *see also Nero Trading, LLC v. U.S. Dep't of Treasury, IRS*, 570 F.3d 1244, 1248 (11th Cir. 2009).

However, the Eleventh Circuit held that Clarke's allegation of improper purpose entitled him to an evidentiary hearing during which he could question IRS officials concerning the reasons for issuing the summons:

> Under our precedents, Appellants were entitled to a hearing to explore their allegation of an improper purpose.[3] As we have explained, in situations such as this, requiring the taxpayer to provide factual support for an allegation of an improper purpose, without giving the taxpayer a meaningful opportunity to obtain such facts, saddles the taxpayer with an unreasonable circular burden, creating an impermissible "Catch 22." *See Nero*, 570 F.3d at 1250; *S.E. First Nat'l Bank*, 655 F.2d at 667. While "the scope of any adversarial hearing in this area is left to the discretion of the district court," binding Circuit authority requires that Appellants be given an opportunity "to ascertain whether the Service issued a given summons for an improper purpose." *Nero*, 570 F.3d at 1249. As required by *Southeast First National Bank*, on remand Appellants should be permitted to "question IRS officials concerning the Service's reasons for issuing the summons[es]." 655 F.2d at 667 (footnote omitted).
>
> > [3] Appellants, however, are not entitled to discovery. We have held that the full "panoply of expensive and time-consuming pretrial discovery devices may not be resorted to as a matter of course and on a mere allegation of improper purpose." *Nero*, 570 F.3d at 1249 (internal quotation and emphasis omitted).

- There has been some speculation that certiorari to the Eleventh Circuit was granted in order that the Supreme Court might re-examine its holding in *United States v. Powell*, 379 U.S. 48 (1964), in which the Court (Mr. Justice Harlan) stated:

> Reading the statutes as we do, the Commissioner need not meet any standard of probable cause to obtain enforcement of his summons, either before or after the three-year statute of limitations on ordinary tax liabilities has expired. He must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps

> required by the Code have been followed—in particular, that the 'Secretary or his delegate,' after investigation, has determined the further examination to be necessary and has notified the taxpayer in writing to that effect. This does not make meaningless the adversary hearing to which the taxpayer is entitled before enforcement is ordered. At the hearing he 'may challenge the summons on any appropriate ground,' *Reisman v. Caplin*, 375 U.S. 440, at 449, 84 S. Ct. at 513. Nor does our reading of the statutes mean that under no circumstances may the court inquire into the underlying reasons for the examination. It is the court's process which is invoked to enforce the administrative summons and a court may not permit its process to be abused. Such an abuse would take place if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation. The burden of showing an abuse of the court's process is on the taxpayer, and it is not met by a mere showing, as was made in this case, that the statute of limitations for ordinary deficiencies has run or that the records in question have already been once examined. (379 U.S. at 57-58) (footnotes omitted).

a. Turnabout is fair play. Summonsed individuals might have the right to grill IRS agents regarding their motives in issuing the summons. United States v. Clarke, 134 S. Ct. 2361 (6/19/14). In the course of a partnership audit the IRS issued a summons to four individuals associated with the partnership whom the IRS believed had information and records relevant to the audit. The individuals refused to comply and the IRS sought enforcement of the summons. In the enforcement proceedings, the summonsed individuals asserted that the IRS had issued the summons for an improper purpose, namely to punish the partnership for refusing to extend the statute of limitations, and sought enforcement for an improper purpose, specifically, that the IRS decided to enforce the summonses, subsequent to the partnership filing suit in Tax Court, to "evad[e] the Tax Court['s] limitations on discovery" and thus gain an unfair advantage in that litigation. In support of their request for an opportunity to question the IRS agents about their motives, the summonsed individuals submitted an affidavit from the attorney of another partnership associate, who had complied with a summons issued at the same time, which reported that only the IRS attorneys handling the Tax Court case, and not the original investigating agents, were present at the interview of his client. The District Court denied the request and ordered compliance, but the Eleventh Circuit reversed. 517 Fed. Appx. 689 (11th Cir. 4/18/13), finding that the District Court's refusal to allow the summonsed individuals to examine IRS agents constituted an abuse of discretion. In support of that ruling, the Court of Appeals cited Fifth Circuit precedent holding that a simple "allegation of improper purpose," even if lacking any "factual support," entitles a taxpayer to "question IRS officials concerning the Service's reasons for issuing the summons." The Supreme Court, in a unanimous opinion by Justice Kagan, vacated the Court of Appeals decision and remanded the case. After initially repeating that under *United States v. Powell*, 379 U.S. 862 (1981), and its progeny "summons enforcement proceedings are to be 'summary in nature,'" and "that courts may ask only whether the IRS issued a summons in good faith, and must eschew any broader role of 'oversee[ing] the [IRS's] determinations to investigate,'" and "absent contrary evidence, the IRS can satisfy that standard by submitting a simple affidavit from the investigating agent," the Court went on to hold as follows:

> As part of the adversarial process concerning a summons's validity the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some credible evidence supporting his charge. But circumstantial evidence can suffice to meet that burden; after all, direct evidence of another person's bad faith, at this threshold stage, will rarely if ever be available. And although bare assertion or conjecture is not enough, neither is a fleshed out case demanded: The taxpayer

> need only make a showing of facts that give rise to a plausible inference of improper motive. That standard will ensure inquiry where the facts and circumstances make inquiry appropriate, without turning every summons dispute into a fishing expedition for official wrongdoing. And the rule is little different from the one that both the respondents and the Government have recommended to us.

The Court went on to remind that (1) the appellate court review of the District Court's decision is for abuse of discretion, but that the "District Court's decision is entitled to deference only if based on the correct legal standard," and (2) the District Court's latitude does not extend to legal issues about what counts as an illicit motive. Finally, the Court specifically declined to opine on whether either of the asserted improper motives for issuance of the summons actually were improper.

- While the taxpayer got a partial victory in *Clarke*, perhaps the most important aspect of the decision is the reaffirmation of the breadth of the IRS's summons power under *Powell* and its progeny.

3. Did the Tax Court just say that anytime the taxpayer raises a § 6664(c)(1) penalty defense attorney client privilege has been waived? AD Investment 2000 Fund LLC v. Commissioner, 142 T.C. No. 13 (4/16/14). In a Son-of-Boss Tax Shelter case, the IRS, in anticipation of the taxpayers raising reasonable cause and good faith affirmative defenses to § 6662 accuracy-related penalties, moved to compel production of the taxpayers' attorneys' opinion letters regarding whether it was more likely than not that anticipated tax benefits from the transactions in question would be upheld. The taxpayers claimed attorney-client privilege. But the IRS argued that the taxpayers impliedly waived privilege by asserting, "Any underpayment of tax was due to reasonable cause and with respect to which the Partnership and its partners acted in good faith." (I.R.C. § 6664(c)(1)). However, the taxpayers denied that these averments brought "professional advice (i.e., the opinions) into question." The IRS conceded that the taxpayers raised only self-determination, and not reliance on professional advice, to show that they satisfied the good-faith belief requirement, but argued, that the taxpayers had "placed the opinions into controversy by relying on a reasonable cause, good-faith defense and by putting the partnerships' beliefs into issue." The Tax Court (Judge Halpern) agreed with the IRS, stating, "When a person puts into issue his subjective intent in deciding how to comply with the law, he may forfeit the privilege afforded attorney-client communications. ... '[A] client waives his attorney privilege when he brings suit or raises an affirmative defense that makes his intent and knowledge of the law relevant.'" The opinion continued:

> Petitioners' averments that the partnerships satisfied the belief requirement by the first method put into dispute the partnerships' knowledge of the pertinent legal authorities. Petitioners' averments also put into contention the partnerships' understanding of those legal authorities and their application of the legal authorities (i.e., the law) to the facts. Finally, the averments put into contention the basis for the partnerships' belief that, if challenged, their tax positions would more likely than not succeed in the courts. Petitioners have thus placed the partnerships' legal knowledge, understanding, and beliefs into contention, and those are topics upon which the opinions may bear. If petitioners are to rely on the legal knowledge and understanding of someone acting for the partnerships to establish that the partnerships reasonably and in good faith believed that their claimed tax treatment of the items in question was more likely than not the proper treatment, it is only fair that respondent be allowed to inquire into the bases of that person's knowledge, understanding, and beliefs including the opinions (if considered).

Thus, the taxpayers had "forfeited the privilege that would otherwise apply to the opinions." Judge Halpern ordered the opinions to be produced and warned that in the event of noncompliance, he would consider prohibiting the taxpayers from introducing evidence that they met the good-faith "belief requirement by self-determination or that someone acting for the partnerships had a good-faith and honest misunderstanding of law."

4. While many of us are still undecided on the post-Clintonian meaning of "is," the Tenth Circuit in a 2-1 decision held that "shall" means "shall." Jewell v. United States, 749 F.3d 1295 (10th Cir. 4/28/14). This appeal from decisions in the Eastern and Western Districts of Oklahoma which quashed and upheld, respectively, four IRS summonses to banks for records involving nursing homes owned by Mr. Jewell in light of the admitted failure of the IRS to give him the 23-day notice period required by the third party summons provision of § 7609(a)(1) and *United States v. Powell*, 379 U.S. 48, 57 (1964), resulted in the quashing of all fours summonses on the ground that the word "shall" in the statute made such notice mandatory. (The district court that upheld the summonses "not[ed]" that taxpayer received the summonses in time to file his petition, while the district court that quashed the summonses "reason[ed]" that the IRS failed to comply with the notice requirement.) The Tenth Circuit (Judge Bacharach) stated that it was upholding "the age-old precept that "shall" means "shall," while being "mindful of the fact that five other circuit courts have declined to apply *Powell* in this manner."

- Judge Tymkovick dissented on the ground that he did "not believe that *Powell* imposes a *per se* bar on enforcement in the event the IRS commits a technical breach of an administrative provision" of the Code, but would "consider whether, under the totality of the circumstances, a court should decline to enforce a summons."

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

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

> This legal analysis makes reference to statutes, IRS regulations, IRS private letter rulings, other administrative materials, and case law. In many instances, the memorandum asserts that there is no law clearly on point and thus uses language such as "although not free from doubt," "the better view is that," "it may be argued," and "it is not inconceivable that the IRS could assert." Additionally, in explaining its recommendations for handling particular aspects of the restructuring and refinancing measures, the memorandum considers at great length the arguments and counter-arguments that could be made by Schaeffler and the IRS with regard to the appropriate tax treatment of these measures. While there is copious citation to relevant legal authority, the memorandum does not specifically refer to litigation — for example, by discussing what actions peculiar to the litigation process Schaeffler or the IRS might take or what settlement strategies might be considered. Rather, the memorandum contains detailed and thorough legal analysis as to the propriety of the planned measures and advocates what specific transactional steps should be taken.
>
> . . . We will also accept that Schaeffler believed that litigation was highly probable in light of the significant and difficult tax issues that were raised by the planned refinancing and restructuring. Accordingly, the Court is called upon to make the factual determination required by *Adlman* [*United States v. Adlman*, 134

F.3d 1194, 1196 (2d Cir. 1998)]: whether this memorandum and the related documents "would have been created in essentially similar form" had litigation not been anticipated. 134 F.3d at 1202. While we have described this as a factual determination, in reality it is a counterfactual determination because it requires the Court to imagine what "would have" happened in a world where Schaeffler did not anticipate litigation as to the restructuring and refinancing transactions but everything else was exactly the same — in other words, Schaeffler still found himself acquiring the unexpectedly large share of Conti stock and still needed to engage in a refinancing and restructuring arrangement that would comply with federal tax laws.

. . . Accordingly, given our assumption that Schaeffler is a rational businessperson who routinely makes efforts to comply with the law, we find that, even had he not anticipated an audit or litigation with the IRS, he still would have had to obtain the type of legal assistance provided by Ernst & Young to carry out the refinancing and restructuring transactions in an appropriate manner.

. . . As to whether Ernst & Young's advice would have been different in content or form had it known that no audit or litigation would ensue, petitioners have presented no facts suggesting that Ernst & Young would have acted any differently. To the contrary, as petitioners recognize, see Letter from M. Todd Welty, dated May 2, 2014 (Docket #52) ("Welty Letter"), **there exists legal authority demanding that tax practitioners not allow the possibility that a tax return will remain unaudited to affect the advice they give**. Treasury Department Circular 230 states:

> In evaluating the significant Federal tax issues addressed in [a tax opinion], the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

[Former] Circular 230, § 10.35(c)(3)(iii). Similarly, a Treasury regulation regarding tax shelters states that in reaching conclusions regarding whether a particular tax position would more likely than not be sustained on its merits,

> the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account.

26 C.F.R. § 1.6694-2(b). In other words, when tax practitioners give advice to clients, they must ignore the actual possibility of an audit — and, by extension, litigation — in opining on the tax implications of a transaction. Thus, when providing legal advice on the tax treatment of the restructuring and refinancing transactions, the Ernst & Young advisors had a responsibility to consider in full the relevant legal issues regardless of whether they anticipated an audit and ensuing litigation with the IRS. (emphasis added)

- Magistrate Judge Gorenstein concluded on the work product issue:

Thus, we conclude that had Schaeffler's tax advisors been asked to opine on the legal implications of the transactions with the knowledge that an audit or litigation would not occur, they "would have" used the same methodology to render tax advice: that is, a close analysis of the relevant legal authorities to determine how various tax positions would be tested in the crucible of litigation.

For these reasons, we find that the EY Tax Memo, as well as the related responsive documents, would have been produced in the same form irrespective of any concern about litigation. Accordingly, these documents are not protected from disclosure under the work product doctrine.

6. Who will be looking at the information your client provided in response to a summons and asking your client questions during the summons interview? It might not be an IRS employee. T.D. 9669, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 79 F.R. 34625 (6/18/14). Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage and reproduction) related to returns or return information. The Treasury has issued proposed and temporary regulations clarifying that such persons with whom the IRS or Chief Counsel contracts for services

> may receive and examine books, papers, records, or other data produced in compliance with [a] summons [issued by the IRS] and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of the witness summoned by the IRS to provide testimony under oath.

The proposed and temporary regulations state that full participation in an interview includes "being present during summons interviews; questioning the person providing testimony under oath; and asking a summoned person's representative to clarify an objection or assertion of privilege." The temporary regulations apply to summons interviews conducted on or after 6/18/14.

- The Tax Section of the State Bar of Texas has submitted comments on the proposed regulations in which the Tax Section recommends that Treasury remove the provision that permits persons providing services to question a witness under oath or ask the witness's representative to clarify an objection or assertion of privilege. Removing this provision, the Tax Section states, would "result in a more orderly proceeding and a cleaner, more comprehensible transcript of the interview" and also "avoid the unsettled question of whether a private contractor has the legal authority to examine a witness." 2014 TNT 180-24 (9/16/14).

7. High tech discovery response is approved by the Tax Court. Dynamo Holdings Limited Partnership v. Commissioner, 143 T.C. No. 9 (9/17/14). The IRS sought to have the taxpayer produce electronically stored information contained on two backup storage tapes or, alternatively, the tapes themselves (or copies thereof). The taxpayer acknowledged that the tapes contained tax-related information but asserted that it would take many months and cost at least $450,000 to fulfill the request because it would need to review each document on the tapes to identify what is responsive and then withhold privileged or confidential information. The taxpayer also requested the Court to deny the IRS's motion as a "fishing expedition" in search of new issues that could be raised in this or other cases. Alternatively, the taxpayer requested that it be allowed to use predictive coding, a technique prevalent in the technological industry but not yet formally sanctioned by the Tax Court, to efficiently and economically identify the nonprivileged information responsive to the IRS's discovery request. The Tax Court (Judge Buch) granted the IRS's motion requiring the taxpayer to respond to the discovery request but allowed the taxpayer to use predictive coding in doing so.

C. Litigation Costs

1. "[U]nder the 'narrow statutory language of section 7430(c)(7)', as well as the Commissioner's interpretive regulations taxpayers * who do a good job at the administrative level of resolving issues and getting respondent to realize the error of his ways are precluded from recovering administrative costs incurred in achieving those favorable results."** Purciello v. Commissioner, T.C. Memo. 2014-50 (3/24/14). The IRS abated its claim against the taxpayer for § 6672 penalty taxes at Appeals and the taxpayer sought to recover administrative costs. Although the taxpayer clearly had substantially prevailed in the administrative proceeding, the Tax Court (Judge Jacobs) denied the request for costs. Even if a taxpayer substantially prevails, the taxpayer is not treated as the prevailing party if the IRS establishes that the "position of the United States" was substantially justified. Section 7430(c)(7)(B) provides "the 'position of the United States' taken in an administrative proceeding is the position the IRS takes as of the earlier of (i) the date of the receipt by the taxpayer of the notice of the decision of the Internal Revenue Service Office of Appeals or (ii) the date of the notice of deficiency." Judge Jacobs agreed with the IRS's argument that the taxpayer was not a prevailing party because the IRS Appeals Office conceded the case and agreed that the taxpayer did not owe any money to the IRS, and for purposes of § 7430, this position was the first time the United States took a position in the case and, "inasmuch as respondent agreed with petitioner's contention, the position taken by the United States was substantially justified."

2. It's hard for the government to deny that the taxpayer is entitled to costs as a prevailing party when it concedes that its assessment was invalid and that its collection action should not be sustained. Swiggart v. Commissioner, T.C. Memo. 2014-172 (8/25/14). On his individual return for 2010, the taxpayer claimed head of household status and paid with the return $2,149 less than the tax liability shown on the return. The IRS issued a notice of summary assessment of the unpaid $2,149 and an additional $2,205 (including tax, a late payment penalty under § 6651(a)(2), and interest) on account of a mathematical error. The notice stated that the additional amount assessed resulted from the IRS changing the taxpayer's filing status to single because the name of the dependent who qualified him for head of household filing status was not reported on the tax return. The IRS soon followed with a Final Notice of Intent to Levy and Notice of Your Right to a Hearing, in which it sought to collect the amount allegedly due plus penalties and interest. Forty-six days after the IRS issued the notice of summary assessment, the taxpayer's attorney mailed by certified mail both a request for abatement and a Form 12153, Request for a Collection Due Process or Equivalent Hearing. The attorney included with the Form 12153 a detailed supporting statement. The IRS responded with a letter stating that it was unable to process the claim for abatement because the taxpayer's supporting information was not complete and the additional information the taxpayer provided did not give the IRS a basis to change the assessment. During the CDP hearing, the taxpayer provided an affidavit in which he identified his child by name and Social Security number and stated that, although he had an agreement with the child's mother to waive the dependency exemption deduction for certain years, including 2010, his child had spent the greater number of nights in 2010 with him. Although the settlement officer agreed that claiming the child as a dependent was not required to qualify as a head of household, the settlement officer concluded that he could not abate the tax attributable to the change in filing status until the taxpayer provided additional documents showing that the child had lived with him for more than half of the year. The IRS then issued a notice of determination sustaining the proposed levy because the taxpayer had not proven that he was entitled to head of household filing status. The taxpayer challenged the notice of determination by filing a petition in the Tax Court. The taxpayer moved for summary judgment, asking the court to conclude that the portion of the assessment attributable to the change in filing status was void and that the IRS could not levy to collect that portion. The IRS conceded that the taxpayer's motion for summary judgment should be granted as to the portion of the assessment attributable to the change in filing status and entered into a stipulation of settled issues in which the parties agreed that the IRS had abated $2,142 of the assessment (without prejudice to the IRS's right to reassess the amount using deficiency procedures). After trial, the taxpayer moved for reasonable administrative and litigation costs pursuant to § 7430, which permits the award of such costs to a prevailing party. The IRS conceded that the taxpayer had exhausted administrative remedies and had not unreasonably protracted the proceedings, and therefore the only issue was whether the taxpayer was a prevailing party. To be a prevailing party, a taxpayer must substantially prevail with respect to either the amount in controversy or the most significant issue or set of issues presented and also meet certain timing and net worth requirements. The IRS conceded, and the court (Judge Buch) concluded that the taxpayer met the timing and net worth requirement. The court also concluded that the taxpayer had substantially prevailed. The court noted that the taxpayer had consistently disputed the portion of the assessment attributable to the unilateral change in filing status, that the only issues presented were the validity of that portion of the assessment and the attempts to collect based on that assessment, and that the IRS had conceded these issues. The government argued that, under § 7430(c)(4)(B), the taxpayer could not be treated as the prevailing party because the government's position was substantially justified. The court rejected this argument.

It noted that the taxpayer had requested abatement within 60 days of the issuance of the math error notice and therefore, under § 6213(b)(2)(A), the IRS was required to abate the assessment, which it had failed to do. Instead, the court observed, the IRS had taken the position both by letter and in the CDP hearing that it would not abate the assessment because the taxpayer had failed to prove he was entitled to head of household filing status. "By statute, the IRS was required to abate the assessment, and requiring [the taxpayer] to prove entitlement to head of household status before abating the assessment was not substantially justified." The court awarded administrative costs and attorneys' fees, but reduced the hourly rate for the attorneys' fees from the requested $250 per hour to the statutory rate ($180 or $190 per hour for the years involved).

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. What was I thinking, signing as the TMP!? An ostensible TMP who executed consents to extend the period of limitations on assessment of partnership items may not, in fact, have been the TMP, but the consents were valid because he was authorized to sign them. Peking Investment Fund, LLC v. Commissioner, T.C. Memo. 2013-288 (12/23/13). As the Tax Matters Partner (TMP) of Peking Investment Fund, LLC (PIF), an LLC taxed as a partnership, an individual named Li Chien Tsai executed Forms 872-P, Consents to Extend the Time to Assess Tax Attributable to Partnership Items, which extended until December 31, 2008, the § 6229(a) period of limitations on assessment with respect to partnership items for certain taxable years. On December 30, 2008, the IRS sent a notice of final partnership administrative adjustment (FPAA) denying loss deductions claimed by PIF. Among other issues in the case, the Tax Court (Judge Halpern) considered whether Mr. Tsai's execution of the Forms 872-P effectively extended the period of limitations on assessment pursuant to § 6229(b)(1)(B), which provides that the period of limitations can be extended "with respect to all partners, by an agreement entered into by the Secretary and the tax matters partner (or any other person authorized by the partnership in writing to enter into such an agreement)." Mr. Tsai, who was granted leave to participate in the case in an earlier proceeding, asserted that the Forms 872-P he executed were invalid and did not effectively extend the period of limitations on assessment because: (1) he was ineligible to be PIF's TMP when he signed them because he had no direct ownership interest in PIF and therefore was not a general partner or member-manager of PIF, and (2) he was not otherwise authorized to sign them. The government challenged only the second assertion. The court concluded that a letter to the IRS from PIF's former TMP, who was the member-manager of PIF, was sufficient authorization within the meaning of § 6229(b)(1)(B). In that letter, the former TMP resigned and appointed Mr. Tsai as TMP. The court reasoned that, although the letter might not have been effective to appoint Mr. Tsai as TMP, it nevertheless expressed the former TMP's (and therefore PIF's) intent to authorize Mr. Tsai to exercise the same authority as the former TMP, including the authority to execute the Form 872-P consents. In reaching this conclusion, the court examined an analogous situation involving a limited partnership in *Investment Engineers, Ltd. v. Commissioner*, T.C. Memo. 1994-255. Based on the former TMP's resignation and its holding out of Mr. Tsai as the TMP, the court also concluded that PIF was "estopped from denying his authority as PIF's ostensible TMP to execute the Form 872-P consents for the years in issue."

2. Only part of the § 6501(e) regulations was invalidated in *Home Concrete & Supply*. Barkett v. Commissioner, 143 T.C. No. 6 (8/28/14). The Tax Court (Judge Goeke) held that gains, as argued by the IRS, and not the total amount realized on a sale of investment assets, as argued by the taxpayer, are used to determine whether there was an omission from gross income that triggered the six-year limitations period in § 6501(e). The Supreme Court's decision in *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), invalidating in part Reg. § 301.6501(e)-1 did not change the result in *Insulglass Corp. v. Commissioner*, 84 T.C. 203 (1985), in which the Tax Court held that "capital gains, and not the gross proceeds, are to be treated as the 'amount of gross income stated in the return' for purposes of section 6501(e) ... on the basis of section 61(a), which defines gross income as 'all income from whatever source derived', including '[g]ains derived from dealings in property'."

F. Liens and Collections

1. BLIPS and bankruptcy: hiding assets after learning losses may be disallowed can make the subsequent tax liability non-dischargeable. Vaughn v. United States, 111 A.F.T.R.2d 2013-1481 (D. Colo. 3/29/13). The taxpayer used losses from a KPMG BLIPS tax shelter to offset gain from the 1999 sale of his interest in a cable company. After being informed by KPMG of the release of Notice 2000-44, 2000-2 C.B. 255, which identified losses in BLIPS-type tax shelters as nondeductible, and learning that the IRS was auditing the cable company's former CFO, who also had used BLIPS losses to offset gain, the taxpayer purchased a $1.7 million home titled in his fiancée's name. After KPMG advised the taxpayer to disclose his BLIPS investment, but before he disclosed it, the taxpayer funded a $1.5 million trust for his stepdaughter. He also spent significant amounts on jewelry and home furnishings. The taxpayer later filed a chapter 11 bankruptcy petition and the IRS filed a proof of claim in that proceeding in the amount of $14,359,592. Under 11 U.S.C. § 523(a)(1)(C), a tax debt is not dischargeable in bankruptcy if the debtor either made a fraudulent return or willfully attempted to evade or defeat the tax. The Bankruptcy Court held that the taxpayer's tax liability was non-dischargeable on both grounds. The District Court affirmed the Bankruptcy Court's determination solely on the ground that the taxpayer had willfully attempted to evade or defeat tax. The District Court rejected the taxpayer's contention that he could not have willfully attempted to evade or defeat tax because there had been no assessment or quantification of his tax liability when he depleted his assets.

a. Best not squander those tax shelter savings before audit and assessment. In re Vaughn, 765 F.3d 1174 (10th Cir. 8/26/14). The Court of Appeals, in an opinion by Judge McKay, affirmed the lower court's holdings. Vaughn "'must have been aware'" of the circumstances demonstrating the invalidity of his BLIPS losses, and [he] chose to claim those losses on his tax returns and to deplete his remaining assets, 'knowing, as he must have, the BLIPS investment constituted an improper abusive tax shelter.'"

2. When the U.S.P.S. Form 3877 isn't properly completed, it's not enough to prove that the IRS sent the deficiency notice. Meyer v. Commissioner, T.C. Memo. 2013-268 (11/25/13). This case was a review of a CDP determination to proceed with a levy. The taxpayer had not filed a tax return and the IRS prepared a substitute for return. The taxpayer claimed that he never received a deficiency notice. The IRS could not produce a copy of the deficiency notice, but the Appeals Officer conducting the hearing relied on a Form 4340, Certificate of Assessments, Payments, and Other Specified Matters, to verify that the Commissioner had properly assessed the tax, and a U.S.P.S. Form 3877 that listed, along with others, the taxpayer's name and address to verify that the deficiency notice had been properly mailed. The taxpayer argued that this determination was an abuse of discretion, because the Appeals Officer did not meet his obligation to verify that the IRS properly issued and mailed a notice of deficiency to him. Citing *Hoyle v. Commissioner*, 131 T.C. 197 (2008), the Tax Court (Judge Holmes) held that "the Appeals officer could not rely on 'computerized records' like the Form 4340, ... but '[t]he Appeals officer may be required to examine underlying documents." Examining the Form 3877 was a step in the right direction according to Judge Holmes, but because the existence of the deficiency notice was in dispute and as a factual matter the Form 3877 itself appeared not to have been properly completed, in this case that one additional step did not suffice. Because the administrative record did not show that the Appeals Officer relied on anything else to verify proper mailing, the case was remanded to the Appeals Officer to independently verify that a deficiency notice was properly issued and mailed.

3. The government successfully detains taxpayers for failing to return a fraudulent tax refund. United States v. Barrett, 113 A.F.T.R.2d 2014-749 (D. Colo. 1/29/14). The taxpayers, a married couple, filed a fraudulent tax return for the 2007 tax year that resulted in a $217,615 tax refund to which they were not entitled. The government brought this action in which it alleged that the taxpayers had removed funds from the United States and sought an order requiring the funds to be repatriated and applied to their tax debt. "In an effort to identify assets available for application to the debt, and to collect such assets, the United States . . . filed an ex parte sealed motion for the issuance of a writ of ne exeat republica against the Barretts. . . . A writ of ne exeat republica is a form of injunctive relief ordering the person to whom it is addressed not to leave the jurisdiction of the court or the state, for example, to aid the sovereign to compel a citizen to pay his taxes." At an evidentiary hearing, the government introduced evidence of assets held by the taxpayers outside the United States. The court characterized these assets—which included a bank account with a balance of $60, used office furniture, and a horse with unknown value—as "dribs and drabs." Nevertheless, because the assets identified by the government would allow the debt to be reduced by $16,000 and also included a 50 percent interest in real property in Ecuador that was purchased for $64,000, the court declined to discharge the writ until the taxpayers pay $16,000 and either sell the real property and provide the proceeds to the government or prove, with credible evidence, that they cannot sell it. The taxpayers have been living with relatives in Colorado since they were detained.

- Jurisdiction is given to district courts to issue this writ in IRC § 7402(a).

4. The government's discharge from federal tax liens of real property taken by the state by eminent domain does not release its claim to damages the property owner later receives as additional compensation for the taking. Hannon v. City of Newton, 744 F.3d 759 (1st Cir. 2/28/14). In addressing what it described as an issue of first impression, the First Circuit (Judge Lynch) held that the IRS's discharge from federal tax liens (in exchange for a payment) of a parcel of real property taken by the state by eminent domain did not release any claim the IRS had on damages the former property owner later received for undercompensation. The IRS held tax liens for over $4 million against property owned by Patrick Hannon, including a parcel of land with a residence he owned in Newton, Massachusetts. The City of Newton asked the IRS to discharge this parcel from its tax lien to facilitate the city's taking of the property by eminent domain. The IRS did so upon receiving from the city $57,214.55, which was an estimate of what would remain of the $2.3 million paid by the city as compensation for the property after the mortgagee, a senior creditor, was paid. After the city took the property, Hannon brought an action in state court claiming that he had not been adequately compensated for the property. He was awarded $420,000 in damages. The government and a lower-priority creditor intervened in the state court action and asserted priority to receive the damages. The government removed the case to federal court. The District Court granted summary judgment to the lower-priority creditor on the basis that the IRS's discharge of the property from federal tax liens in exchange for a payment meant that the government had relinquished any claim on the subsequent damages. The First Circuit reversed and directed the District Court to enter summary judgment in favor of the government. The Court of Appeals rejected the lower-priority creditor's argument that, "because § 6325(b)(3) sets forth a specific mechanism for maintaining liens on proceeds from the sale of discharged property, the government's failure to use that mechanism surrendered its liens on proceeds resulting from the post-taking suit for undercompensation." The Court of Appeals analyzed § 6325(b)(2), which authorizes the IRS to discharge property from federal tax liens upon receiving a payment at least equal to the value of the United States' interest in the property to be discharged, and concluded that the language in the Certificate of Discharge in this case was precise and released only the parcel of land that the city was taking. It did not release, the Court of Appeals concluded, property that Hannon later acquired, including the $420,000 in undercompensation damages. The Court of Appeals also held that, because federal law, rather than state law, controlled the attachment of federal tax liens and the scope of the IRS's discharge, the state law doctrine of equitable conversion did not remove the federal tax lien from the undercompensation damages.

5. What part of "impartial" does the IRS not understand? Moosally v. Commissioner, 142 T.C. No. 10 (3/27/14). The key issue in this CDP case was whether the IRS Appeals Office settlement officer to whom the taxpayer's case and hearing were assigned was an impartial officer as required by § 6320(b)(3). The facts, in brief, are that the IRS rejected the taxpayer's offer-in-compromise (OIC) for trust fund recovery penalties for two quarters in 2000, and her income tax liability for 2008. She appealed and the IRS assigned Appeals Officer Smeck to review the OIC. The IRS also had filed a Notice of Federal Tax Lien (NFTL) and issued a Letter 3172. The taxpayer requested a CDP hearing and the IRS assigned Appeals Officer Kane to conduct the CDP hearing. After Smeck had begun review of the OIC, the IRS transferred the taxpayer's CDP case from Kane to Smeck, who sustained the rejection of the taxpayer's OIC and sustained the filing of the NFTL. The taxpayer petitioned for Tax Court review of the CDP determination sustaining the NFTL, on the ground that Smeck was not impartial. The Tax Court (Judge Wells) sustained the taxpayer's appeal. Section 6320(b) requires that a CDP hearing must be conducted by an impartial officer or employee of Appeals. An impartial officer or employee is one who has had no prior involvement with respect to the unpaid tax specified in § 6320(a)(3)(A) before the first hearing under § 6320 or § 6330. The taxpayer's argument was that Smeck was not an impartial officer because Smeck had reviewed the appeal of the rejected OIC before conducting the CDP hearing for the same periods. The IRS argued that Smeck "was an impartial officer because she had not yet issued a determination and that there is no 'prior' involvement when a reviewing officer has not made any determination with respect to the previously rejected OIC." and that § 6320 "contemplates simultaneous review of all issues related to collections during the CDP hearing and that a simultaneous review benefits taxpayers." Judge Wells held that Smeck was not impartial because she "had prior involvement with [the taxpayer's] unpaid tax liabilities for the periods in issue before she was assigned to handle petitioner's CDP hearing for the same taxes and periods in issue. Smeck had reviewed the taxpayer's appeal of her rejected OIC for nearly three months before the CDP hearing was transferred to her, and in that period had obtained and evaluated various documents, forms, and other financial information to calculate the taxpayer's reasonable collection potential and evaluate the rejected OIC. Judge Wells also rejected the IRS's argument that § 6320 "contemplates simultaneous review of all issues related to collections during the CDP hearing and that all collection matters may be handled by the same officer." Such consolidation, he held, is limited to situations involving a lien CDP hearing pursuant to § 6320 and a pre-levy CDP hearing pursuant to § 6330 regarding the same unpaid liability. Reg. § 301.6320-1(d)(1) does not allow "the combination of CDP hearings with non-CDP matters, such as the OIC rejection appeal involved in the instant case." Judge Wells also rejected the IRS's argument that the purpose of § 6320(b)(3) is limited to preventing "an Appeals officer from examining a taxpayer's underlying liability during the examination function and then handling a CDP hearing involving the same liability during the enforcement function." He concluded that § 6320(b)(3) "does not contemplate a permissive interpretation excepting all matters concerning the taxpayer's ability to pay." Accordingly, the case was remanded for a new CDP hearing before an impartial Appeals officer.

6. The IRS takes on the Puyallup Tribe of Indians and loses: tribal per capita payments authorized after the IRS issues a notice of levy are not subject to levy. United States v. Puyallup Tribe of Indians, 113 A.F.T.R.2d 2014-1749 (W.D. Wash. 4/9/14). The IRS issued a notice of levy to the Puyallup Tribe of Indians to collect unpaid taxes owed by a member of the tribe. Despite the levy, the tribe made distributions of tribal revenue, known as per capita payments, to the individual who owed the unpaid taxes. The government brought this action asserting a claim for the tribe's failure to honor the levy. The District Court (Judge Settle) noted that there is conflicting authority on the question whether per capita payments are "property" or "rights to property" within the meaning of § 6331, the provision that authorizes IRS levies. The court found it unnecessary to address this issue because a second issue, which it characterized as a matter of first impression, was dispositive. Under Reg. § 301.6331-1(a), "a levy extends only to property possessed and obligations which exist at the time of the levy. Obligations exist when the liability of the obligor is fixed and determinable although the right to receive payment thereof may be deferred until a later date." The court concluded that the per capita payments were not fixed and determinable because they are made at the discretion of the Tribal Council. Therefore, "a levy may attach to a tribal member's currently authorized per capita payment, but may not reach subsequently authorized per capita payments." The court granted the tribe's motion for summary judgment.

7. The "statutory and regulatory framework does not immunize the IRS from using common sense." The IRS failed to exercise reasonable diligence in ascertaining the taxpayer's last known address when it sent a notice of levy to an address from which previous correspondence had been returned undelivered. Music v. United States, 17 F. Supp. 3d 1327 (N.D. Ga. 4/17/14). The taxpayer was a schoolteacher who failed to file tax returns for fifteen or more years and had a history of moving without leaving a forwarding address with the Postal Service. The last tax return she filed listed her address as Summerfield, Florida. The IRS sent subsequent correspondence to addresses in Georgia, which the IRS obtained from the taxpayer's W-2 or from correspondence that the taxpayer submitted. One IRS letter sent to her Summerfield, Florida address was returned undelivered, and the IRS readdressed it to her Georgia address. After successfully corresponding with the taxpayer at her Georgia addresses, the IRS sent a notice of deficiency, notice and demand for payment, and notices of intent to levy, all to her Summerfield, Florida address. When the taxpayer failed to respond, the IRS issued a notice of levy to her employer in Georgia. The day after she received her levied paycheck, she quit her job. The taxpayer brought this action under § 7433, which allows a taxpayer to recover damages incurred due to the intentional, reckless, or negligent disregard of any provision of Title 26 by an IRS officer or employee in connection with collecting the taxpayer's federal tax. The District Court (Judge O'Kelley) agreed with the taxpayer that the IRS had negligently violated § 6331(d), which requires the IRS to notify the taxpayer in writing of the intent to levy by doing one of the following at least 30 days before the levy: giving the notice in person, leaving it at the taxpayer's dwelling or usual place of business, or sending it by certified or registered mail to the taxpayer's last known address. The IRS violated § 6331(d), the court said, "by sending notices of intent to levy to an address when previous letters sent to that address were returned undeliverable." However, the court characterized the taxpayer's victory as "somewhat pyrrhic" because it concluded that "the entirety of her requested damages were not proximately caused by the IRS' negligence and even if they were, she could have reasonably mitigated the damages." The court allowed the taxpayer to recover costs of the action—the $350 fee to file her complaint—and acknowledged "that its interpretation of the statute [as allowing the taxpayer to recover costs when the taxpayer has not suffered any actual, direct economic damages] conflicts with a significant number of courts that have dismissed section 7433 claims by holding that the plaintiff did not suffer any actual, direct economic damages."

8. You can't order the IRS to levy on particular assets—it gets to choose what to take. Kraft v. Commissioner, 142 T.C. No. 14 (4/23/14). In review of a levy CDP proceeding, the Tax Court (Judge Wherry) held that the IRS did not abuse its discretion in deciding to collect a tax liability from the taxpayer's personal assets rather than by levying on a trust of which the taxpayer was a beneficiary. The IRS is not required to grant a taxpayer's request to collect a tax liability from a particular source.

9. Constructive receipt of a deficiency notice for someone who played two of the three monkeys. Onyango v. Commissioner, 142 T.C. No. 24 (6/24/14). Section 6330(c)(2)(B) allows a taxpayer to contest the underlying tax liability in a CDP hearing only if he did not actually receive a deficiency notice or otherwise have an opportunity to dispute the liability. In this case, on several occasions the Postal Service attempted unsuccessfully to deliver a deficiency notice that had been mailed to him at his legal residence by certified mail, return receipt requested. On at least two occasions the Postal Service left notices of attempted delivery of the certified mail which contained the notice of deficiency at the address of the taxpayer's legal residence, and informed the taxpayer that it had certified mail to deliver to him and that he had to sign a receipt for that mail before the Postal Service would deliver it to him. The taxpayer declined to check on a regular basis his mailbox at his legal residence and to retrieve on a regular basis any Postal Service mail items delivered there. After several unsuccessful attempts to deliver the certified mail, the Postal Service returned it to the IRS. The Tax Court (Judge Chiechi) held that a taxpayer who is reasonably able and had multiple opportunities to check his mail and intentionally fails to do so for the purpose of avoiding receipt of the deficiency notice cannot contend that for purposes of § 6330 he did not receive the deficiency notice. Accordingly, the taxpayer was not permitted to contest his liability in the CDP hearing.

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10. A Notice of Intent to Levy is not a levy. Eichler v. Commissioner, 143 T.C. No. 2 (7/23/14). The taxpayer requested a partial pay installment agreement of assessed taxes. Before the request was acted upon, the IRS mailed Letters CP 90, Final Notice—Notice of Intent to Levy and Notice of Your Right to a Hearing. The taxpayer timely requested a CDP hearing, renewing his request for an installment agreement and asserting that the Letters CP 90 should be withdrawn as invalid pursuant to § 6331(k)(2), which prohibits the IRS from making a levy while an offer for an installment agreement is pending. During the CDP hearing the settlement officer conditioned acceptance of an installment agreement on the taxpayer making an $8,520 down payment. The taxpayer declined to make the payment claiming economic hardship, and the settlement officer's final determination rejected the taxpayer's request that the Letters CP 90 be withdrawn as invalid and sustained the proposed levy on the ground that the taxpayer had declined the proposed installment agreement. The Tax Court (Judge Thornton) held that § 6331(k)(2) did not preclude IRS from issuing the Letters CP 90 after the taxpayer submitted his offer for an installment agreement—§ 6331(k)(2) bars the IRS from making a levy while a taxpayer's offer for an agreement request is pending, but does not bar the IRS from issuing notices of intent to levy—and that the determination not to rescind the Letters CP 90 was not an abuse of discretion under relevant provisions of the IRM. But because the record did not allow for meaningful review of the determination regarding the appropriateness of the $8,520 downpayment as a condition of an installment agreement, the case was remanded for further proceedings.

11. No pre-levy remedy for you; if you're unhappy go to District Court after the levy. Greenoak Holdings Limited v. Commissioner, 143 T.C. No. 8 (9/16/14). The IRS issued a final notice of intent to levy to an estate to collect unpaid estate taxes. The estate requested a § 6330 CDP hearing. Following the hearing, the appeals officer issued a notice of determination sustaining the proposed levy as to nonprobate assets. Among the nonprobate assets reported on the estate tax return was an offshore trust that owned certain entities. The estate did not seek Tax Court review but the entities owned by the offshore trusts petitioned the Tax Court for review of the notice of determination. The IRS moved to dismiss for lack of jurisdiction. The Tax Court (Judge Ruwe) held that the "person entitled to the rights and protections under § 6330 is the taxpayer liable for unpaid federal tax. The Tax Court lacked jurisdiction over a petition filed by a party who is neither the taxpayer nor an authorized representative of the taxpayer. The remedy for persons other than taxpayers who claim ownership rights in property subject to levy lies in the right to make a wrongful levy claim under § 7426(a)(1).

12. The taxpayer won the initial skirmish, but lost the big battle and thus the war. Buczek v. Commissioner, 143 T.C. No. 16 (10/6/14). The taxpayer filed a timely request for a CDP hearing in response to a final notice of intent to levy to collect an unpaid income tax liability. The request did not raise any issues specified in § 6330(c)(2) or make any allegations that reasonably indicated he was raising such an issue. The Appeals Office sent the taxpayer a letter stating that, pursuant to § 6330(g), it was disregarding the hearing request because it was frivolous and that the IRS would proceed with collection. The taxpayer filed a timely petition for review. The Tax Court (Judge Dawson) held that it has jurisdiction to review the IRS's determination as to whether a taxpayer who has sought judicial review under § 6330(d)(1) has raised an issue other than issues that have been identified by the IRS as frivolous or that reflect a desire to delay or impede the administration of Federal tax laws. However, because the taxpayer did not raise any issues specified in § 6330(c)(2) that could be considered in a CDP hearing, no portion of the taxpayer's request for a hearing was excluded from the IRS's determination to disregard the entire request and § 6330(g) prohibited further judicial review of that determination. Thus, because the determination that the IRS could proceed with collection was not made in response to a proper request for a hearing, the Tax Court lacked jurisdiction to review that determination.

13. Another case in which the Tax Court says new issues can be raised in court that weren't raised in the CDP hearing. Lee v. Commissioner, 144 T.C. No. 3 (1/21/15). The IRS filed a tax lien against the taxpayer for § 6672 trust fund recovery penalties and sent a notice of intent to levy. The taxpayer requested a CDP hearing pursuant to §§ 6320 and 6330.

The Appeals Officer sustained the lien and proposed levy. After the taxpayer petitioned the Tax Court for review, the IRS took the position that the taxpayer could not challenge the underlying tax liability because he had previously had an opportunity to do so in response to a Letter 1153. The IRS conceded that it had not mailed the Letter 1153 to the taxpayer's last known address and contended that it had personally served it on him. The taxpayer denied that the Letter 1153 had been served on him. The Tax Court (Judge Wells) denied the IRS's motion for summary judgment because the issue of whether the Letter 1153 was properly issued to the taxpayer by personal service remained a genuine dispute as to a material fact for trial. Furthermore, the issue of whether a Letter 1153 has been properly issued to a taxpayer by mailing or by personal service pursuant to §§ 6672 and 6212(b) is a requirement that the Tax Court will review pursuant to § 6330(c)(1) without regard to whether the taxpayer raised the issue at the CDP hearing.

G. Innocent Spouse

H. Miscellaneous

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

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

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

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

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

2. This case is just like *Loving v. Virginia*, 388 U.S. 1 (1967), except that, instead of freeing interracial couples from discriminatory marriage laws, it is about freeing marginal tax return preparers from discriminatory competence testing. Loving v. IRS, 917 F. Supp. 2d 67 (D. D.C. 1/18/13). The District Court (Judge Boasberg) enjoined the IRS from regulating otherwise unregulated "tax-return preparers" because they are not "representatives" and do not "practice" before the IRS and are not covered under 31 U.S.C. § 330(a) (authorizing the regulation of "the practice of representatives of persons before the [IRS]"). The regulation of tax-return preparers under Circular 230, including registration, payment of fees, passing a qualifying exam, and completing continuing education courses annually, fails the *Chevron* step one test because preparation of tax returns does not require that a "representative demonstrate … (D) competency to advise and assist persons in presenting their cases," 31 U.S.C. § 330(a)(2)(D), on the ground that "[a]t the time of filing, the taxpayer has no dispute with the IRS; there is no 'case' to present." Judge Boasberg also noted that the "unstructured independence by the IRS [under Circular 230] would trample *the specific and tightly controlled penalty scheme in Title 26*" (emphasis added).

- Note that there is neither privilege nor work product protection for communications to a tax return preparer, which arises only when there is a realistic possibility of "controversy."

a. The injunction is modified, but not stayed. Loving v. IRS, 920 F. Supp. 2d 108 (D.D.C. 2/1/13). On the IRS's motion to stay the injunction, Judge Boasberg – while refusing to stay the injunction – modified it to make clear that its requirements were less burdensome than the IRS claimed. The requirement that each tax return preparer obtain a PTIN (and pay related fees) is authorized under § 6109(a)(4), so it may continue, except that the "IRS may no longer condition PTIN eligibility on being 'authorized to practice' under 31 U.S.C. section 330." Therefore, "the requirements that tax return preparers (who are not attorneys, CPAs, enrolled agents, or enrolled actuaries) must pay fees unrelated to the PTIN, pass a qualifying exam, and complete annual continuing-education requirements" continue to be enjoined.

b. Government's motion for a stay pending appeal was denied summarily. Loving v. IRS, 111 A.F.T.R.2d 2013-1384 (D.C. Cir. 3/27/13) (Rogers, Tatel, and Brown, JJ, per curiam) (unpublished). The IRS appealed these two opinions and orders to the Circuit Court for the District of Columbia Circuit, 2/20/13. That court refused to stay the District Court's injunction on the ground that the IRS failed to satisfy "the stringent requirements for a stay pending appeal."

c. The D.C. Circuit found that registered (?) tax return preparers were entitled to be unqualified. The IRS had de gall to require character, competence, and continuing education for "independent" tax return preparers who only needed PTINs to continue preparing error-laden tax returns for their unsophisticated clientele. Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2/11/14), *aff'g* 920 F. Supp. 2d 108 (D. D.C. 2/1/13). The D.C. Circuit (Judge Kavanaugh) held that regulations issued in 2011 under 31 U.S.C. § 330 that imposed new character, competence, and continuing education requirements on tax return preparers were "foreclose[d] and render[ed] unreasonable" by the statute, and thus failed at the *Chevron* step 1 standard. They would have also failed at the *Chevron* step 2 standard because they were "unreasonable in light of the statute's text, history, structure, and context."

- Judge Kavanaugh's opinion found six problems with the 2011 regulations: (1) tax return preparers were not "representatives" because they are not "agents" and, thus, lack "legal authority to act on the taxpayer's behalf"; (2) the preparation and filing of a tax return did not constitute "practice … before the Department of the Treasury" because that term implies "an investigation, adversarial hearing, or other adjudicative proceeding"; (3) the history of the statutory language originally enacted in 1884 "indicated that the statute contemplated representation in a contested proceeding"; (4) the regulation was inconsistent with the "broader statutory framework," (?!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the IRS had authority to regulate tax-return preparers; (5) the statute would have been clearer had it granted power "for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry" ["the enacting Congress did not intend to grow such a large elephant in such a small mousehole"]; and (6) the IRS's past approach showed that until 2011 it never maintained that it had authority to regulate tax return preparers.

- Judge Kavanaugh concluded: "The IRS may not unilaterally expand its authority through such an expansive, atextual, and ahistorical reading of Section 330."
- The DOJ is mulling over whether to seek *en banc* review.

d. Does this mean that all tax return preparers can now charge contingent fees for tax return preparation, e.g., a percentage of the tax refund? Ridgely v. Lew, 114 A.F.T.R.2d 2014-5249 (D. D.C. 7/16/14). A practicing CPA brought suit to challenge Circular 230, § 10.27, which prohibited tax practitioners from charging contingent fees for certain services relating to preparing or filing tax returns or refund claims. He argued that the IRS exceeded the scope of its statutory authority in regulating the preparation of "Ordinary Refund Claims," i.e., refund claims that practitioners file after a taxpayer has filed his original tax return but before the IRS has initiated an audit of the return. On motion for summary judgment, District Judge Cooper granted the CPA's motion and enjoined the IRS from enforcing § 10.27. He noted that "[t]his Court, however, is not the first to venture down this particular rabbit hole," and that *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), "is controlling precedent that must guide [his] examination of [31 U.S.C. § 330's] text, context, and history with respect to the claims at issue . . . ." He rejected the IRS's argument that it has the power to regulate plaintiff's practice as a CPA before it, because that power does not extend regulation of those of his activities which do not constitute practice, i.e., preparation and filing of refund claims.

e. There is life after suspension for CPAs to prepare tax returns. "Some Suspended or Disbarred Tax Practitioners Are Now Permitted To Obtain PTINs and Prepare Tax Returns," IRS announcement dated 8/26/14, found at www.irs.gov/Tax-Professionals/Tax-Pro-News-and-Events (last viewed 9/13/14). This announcement is based on *Loving v. IRS*, which held that tax return preparation, without more, does not constitute representation within the meaning of 31 U.S.C. § 330, and the IRS may not include a restriction on return preparation for compensation. It applies to individuals who were suspended or disbarred, with PTIN access blocked between 8/2/11 and 2/11/14; individuals sanctioned before or after these dates did not have their PTIN access blocked.

- Circular 230, § 10.24 provides with respect to disbarred or suspended persons:

> § 10.24 Assistance from or to disbarred or suspended persons and former Internal Revenue Service employees.
> A practitioner may not, knowingly and directly or indirectly:
> (a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

3. In light of the IRS loss in *Loving v. IRS*, a new, voluntary Annual Filing Season Program to give tax return preparers the ability to claim they hold "a valid Annual Filing Season Program Record of Completion" and that they have "complied with the IRS requirements for receiving the Record of Completion." Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14). In order to encourage unenrolled tax return preparers, i.e., those who are not attorneys, CPAs or EAs, to complete continuing education courses in order to get a better understanding of federal tax law, the carrot of being able to claim superiority to the ordinary run-of-the-mill slob tax return preparers is offered. The requirements for this voluntary program include a six-hour refresher course, with a 100-question test at the end, plus other continuing education of two hours of ethics and ten hours of federal tax law topics. Holders of the Record of Completion may not use the terms "certified," "enrolled," or "licensed" to describe the designation.

4. **Not having access to a cooperating witness's returns does not violate the defendant's Sixth Amendment right to confront witnesses in a prosecution for preparing and filing false tax returns.** United States v. Love, 533 Fed. Appx. 548 (6th Cir. 1/29/14). The defendant worked as a tax return preparer at an H&R Block branch located in a Walmart in Toledo, Ohio. A jury found her guilty on one count of conspiring to prepare false tax returns and fifty-nine counts of aiding the preparation and filing of false tax returns. According to the evidence at trial, the defendant prepared false returns that resulted in refunds for people referred to her by her cousin, Sonya Moses. Moses cooperated with the government in the defendant's prosecution. The defendant argued on appeal that not having access to Moses's tax returns violated her Sixth Amendment right to confront the witnesses against her because the returns would have aided in her cross-examination of Moses. In an opinion by Judge Donald, the Sixth Circuit rejected the defendant's argument and concluded that the district court did not abuse its discretion or impermissibly impede the defendant's right to confront and cross-examine Moses. The court also rejected her argument that the government did not present sufficient evidence to prove beyond a reasonable doubt that she knew that the incomes reported in the returns of certain persons were false.

5. **Whistleblowers' motions to proceed anonymously to obtain judicial review of awards were granted in light of risk of severe physical harm if their identities were to be revealed.** Whistleblower 11332-13W v. Commissioner, T.C. Memo. 2014-92 (5/20/14); Whistleblower 10949-13W v. Commissioner, T.C. Memo. 2014-94 (5/20/14). In these two cases, the Tax Court (Judge Kroupa) granted motions to seal and proceed anonymously by two whistleblowers each of whom had been intimidated with physical force and armed men on behalf of their employer and related entities ("targets") – which paid more than $30 million in taxes, penalties and interest. The Commissioner did not object to these motions and the targets did not participate in these proceedings. Judge Kroupa stated that the general presumption of openness of judicial proceedings was outweighed by the "demonstrated risk of physical harm to [the whistleblower] or [the whistleblower's] family." The motions were based upon a recently-adopted Tax Court Rule 345, which created a mechanism to preserve the anonymity of whistleblowers and non-party taxpayers.

- It seems that these two whistleblowers worked for the same employer, although the opinions did not so state. Reading between the lines of these opinions, it appears that the targets were well aware of the identities of the whistleblowers. In light of this, what was gained by granting anonymity? One possibility is that sealing the cases did protect the identities of the lawyers involved.

a. **Whistleblower's motion to proceed anonymously was granted in light of whistleblower being retired and receiving retirement benefits from his former employer.** Whistleblower 13412-12W v. Commissioner, T.C. Memo. 2014-93 (5/20/14). The Tax Court (Judge Kroupa) granted whistleblower's motion to proceed anonymously seeking review of Commissioner's determination and to have the record sealed. The whistleblower reported the nature of tax violations by his former employer and provided legal analysis and reasoning for Commissioner to proceed against the target, but Commissioner "issued the whistleblower a letter indicating that he was unable to collect any amounts on the whistleblower's claim." The whistleblower is retired and receives retirement benefits from his former employer, the target. While no threat of physical harm was alleged, the whistleblower alleges the possibility of "suffer[ing] professional ostracism, harm and job-related harassment because other potential employers will unlikely want to hire or employ a known whistleblower." Judge Kroupa decided to "err on the side of caution" despite her belief "that distributions from an employer's retirement plans are governed by the plan's provisions and an independent trustee that has fiduciary obligations."

b. **Tax Court has jurisdiction to review a whistleblower claim and award determination where the claim is based on information provided both before and**

after 12/20/06, which was the effective date of § 7623(b). Whistleblower 11332-13W v. Commissioner, 142 T.C. No. 21 (6/4/14). The Tax Court (Judge Kroupa) decided that it had jurisdiction to review a whistleblower claim award determination where the claim was based on information provided both before and after the 12/20/06 effective date of § 7623, which was added by the Tax Relief and Health Care Act of 2006.

- To the same effect is Whistleblower 10949-13W v. Commissioner, T.C. Memo. 2014-106 (6/4/14), also decided by Judge Kroupa.

6. The IRS didn't get to collect a concededly duplicate refund because it took a wrong turn at the fork in the road. YRC Regional Transport, Inc. v. Commissioner, T.C. Memo. 2014-112 (6/10/14). The IRS issued a duplicate refund to the taxpayer through a clerical error and attempted to recover it through a deficiency proceeding. The Tax Court (Judge Kerrigan) held that IRS could not recover the refund—a nonrebate refund—pursuant to a deficiency procedure because there had been no redetermination of the taxpayer's tax liability. The government could recover the erroneous refund only pursuant to suit under § 7405 or under any available administrative collection procedures.

7. Those proposed Circular 230 regulations are now final, so you can – but need not – remove those mindless disclaimers from your emails. But if they remain, they cannot refer to the IRS or Circular 230. T.D. 9668, Regulations Governing Practice Before the Internal Revenue Service, 79 F.R. 33685 (6/12/14). The final Circular 230 regulations include the following:

- The rigid covered opinion rules in former § 10.35 (which required that the written opinion contain a description of the relevant facts, the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts) are removed; these rules are replaced with a single standard for all written tax advice under final § 10.37. This standard requires that the practitioner must: (i) base the written advice on reasonable factual and legal assumptions; (ii) reasonably consider all the relevant facts that the practitioner knows or "**reasonably** should know"; (iii) use reasonable efforts to identify and ascertain the facts relevant on each Federal tax matter; (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable; (v) **"relate applicable law and authorities to facts"**; and (vi) not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. The determination of whether a practitioner has failed to comply with these requirements is based on all the facts and circumstances, not on whether each requirement is addressed in the written advice. Note: Material new in the final regulations is in boldface. The preamble makes clear that practitioners may consider the "the existence or nonexistence of legitimate hazards that may make settlement more or less likely."

- As to disclaimers, the preamble states that "Treasury and the IRS expect that these amendments will eliminate the use of a Circular 230 disclaimer in e-mail and other writings," but they "do not, however, prohibit the use of an appropriate statement describing any reasonable and accurate limitations of the advice rendered to the client." While continuing education presentations are not considered written advice on a Federal tax matter for purposes of § 10.37, "Treasury and the IRS nonetheless expect that practitioners will follow the generally applicable diligence and competence standards under §§ 10.22 and 10.35 when engaged in those activities." The authors of this outline, therefore, use the following statement to describe the limitations with respect to any of the information contained in the outline, "Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right."

- Final § 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS (including providing written opinions), which includes the required knowledge, skill, thoroughness, and preparation necessary for the matter for which he is engaged. This complements the provision in § 10.51 that a practitioner can be sanctioned for incompetent conduct.

- Final § 10.36 conforms the "procedures to ensure compliance" with the removal of the covered opinion rules in former § 10.35, but expands these "procedures to ensure compliance" to include the provisions of subparts A, B, and C of Circular 230.

- Final § 10.1 provides that the Office of Professional Responsibility – as opposed to the IRS Return Preparer Office – will have exclusive responsibility for matters related to practitioner discipline.
- Final § 10.82 extends the expedited disciplinary procedures for immediate suspension, but limits it to practitioners who have engaged in a pattern of willful disreputable conduct by failing to make an annual Federal tax return during four of five tax years immediately before the institution of the expedited suspension proceeding, provided that the practitioner is also noncompliant at the time the notice of suspension is served.
- Final § 10.31 forbids practitioners from negotiating any taxpayer refunds, which specifically adds manipulation of any electronic refund process.
- The effective date of the provisions added or amended by the final regulations is 6/12/14.

8. "Final" means "final"; mulligans not allowed. Snow v. Commissioner, 142 T.C. No. 23 (6/17/14). In an earlier decision, T.C. Memo. 1996-457, the Tax Court held that deficiency notices mailed to the taxpayer were valid. The 1996 final order reached the opposite result from the Special Trial Judge's initial report, which would have held the deficiency notices were invalid. The taxpayer filed a motion to vacate the original decision, apparently relying on *Ballard v. Commissioner*, 544 U.S. 40 (2005), and the resulting revisions to Tax Court Rule 183, which require that the initial report of the Special Trial Judge be provided to the parties and allow them to submit written objections before the report is reviewed by a regular Judge. The Tax Court (Judge Ruwe) denied the motion, which was filed almost 8 years after taxpayer first learned of the Special Trial Judge's initial report and over 16 years after the decision had become final. Generally, once a Tax Court decision becomes final, the court lacks jurisdiction to vacate that decision. There are three possible exceptions: (1) when the Tax Court may have originally lacked jurisdiction to enter a final decision; (2) when there is a fraud upon the court; and (3) mutual mistake, where the Tax Court decision was predicated on the parties' stipulation, and both the government and the taxpayer concede they mistakenly entered into the stipulation. None of them were present in this case.

9. "Where a statute is capable of various interpretations, we are inclined to adopt a construction which will permit the Court to retain jurisdiction without doing violence to the statutory language." Comparini v. Commissioner, 143 T.C. No. 14 (10/2/14). The petitioners filed a claim for a whistleblower award under § 7623(b). In 2012 the Whistleblower Office sent four essentially identical letters to the petitioners stating that they were not eligible for an award and inviting them to contact the Whistleblower Office with any questions. Subsequently, the petitioners submitted additional information in support of their claim. In 2013 the Whistleblower Office sent the petitioners a letter stating that it had "determined your claim still does not meet our criteria for an award," "[o]ur determination remains the same," and "we are closing this claim." The petitioners filed a petition for Tax Court review under § 7623(b)(4) within 30 days after receiving the 2013 letter. The IRS moved to dismiss on the ground that the petition filed in response to the 2013 letter was untimely because it had not been filed within 30 days after the determination in the 2012 letters. In a reviewed opinion by Judge Colvin (in which eight judges joined and with a number of concurring opinions), the Tax Court held that the 2013 letter constituted a determination for purposes of § 7623(b)(4) and denied the IRS's motion to dismiss for lack of jurisdiction. The 2013 letter from the Whistleblower Office was a "determination regarding an award" within the meaning of § 7623(b)(4) and because the petitioners filed a petition within 30 days of that letter, the court had jurisdiction. "[T]he 2013 letter constitutes a determination and … its status as a determination is not negated ... by the fact that the Whistleblower Office sent the 2012 letters." It is "possible for the Whistleblower Office to issue, as to a given claim, more than one 'determination' on which [Tax Court] jurisdiction might be based."

- A joint concurring opinion by Judges Halpern and Lauber (in which four other judges joined) agreed that the Whistleblower Office "can make more than one ‘determination’ with respect to a claimant's claim or universe of claims.” But the concurring opinion would have expressly limited the holding to cases where the subsequent claim differs from the earlier claim; “if the claim is not different and the determination is the same, and if the petition is filed more than 30 days after the original determination, the Court should hold that it lacks jurisdiction ... .”

10. Once Tax Court jurisdiction is properly invoked, the IRS can’t undo it by saying “sorry, we sent the letter by mistake.” Ringo v. Commissioner, 143 T.C. No. 15 (10/6/14). The petitioner filed a claim for a whistleblower award under § 7623(b). On Nov. 7, 2012, the Whistleblower Office mailed to him a letter stating that he was ineligible for an award because he had not provided the IRS with information that resulted in the collection of any tax from the target. The petitioners filed a timely petition for Tax Court review under § 7623(b)(4). On June 11, 2013, the Whistleblower Office notified the petitioner that it was still considering the application and that it had mailed the Nov. 7, 2012, letter in error. The IRS then moved to dismiss the case for lack of jurisdiction. The Tax Court (Judge Colvin) held that the Nov. 7, 2012, letter was a determination and that the Tax Court had jurisdiction with respect to the matter. Furthermore, the fact that the IRS continued to consider the petitioner’s claim after sending the Nov. 7, 2012, letter did not terminate the Tax Court’s jurisdiction.

11. Bad guys finish last. Rader v. Commissioner, 143 T.C. No. 19 (10/29/14). The taxpayer worked and earned income but failed to file returns for several years. The IRS prepared substitutes for returns for those years and issued deficiency notices. The Tax Court (Judge Halpern) rejected the taxpayer’s argument that the substitutes for returns were not valid because they did not include a Form 1040. Furthermore, the IRS had the right to elect to treat the taxpayer as married filing separately in properly filed amendments to its answer, which resulted in increased deficiencies. The court sustained the deficiencies determined by the IRS. The court also rejected the taxpayer’s claim that he was entitled to an offset against the deficiency for one year equal to the amounts withheld under § 1445 from the proceeds from two real estate sales in that year. Although § 1445 applies to payments made to foreign persons for the disposition of U.S. real property, and the taxpayer was a U.S. citizen, the withholding resulted from the taxpayer’s failure to provide a tax identification number to the escrow agent. The improper withholding did not give rise to a § 31 credit (wage withholding), but rather to a credit under § 33 (withholding on nonresident aliens), and under § 6211(b)(1) a § 33 credit expressly is disregarded for purposes of computing a deficiency. The court also held that the taxpayer’s wife wasn’t entitled to a refund of the overpayment because a refund claim would not have been timely. Penalties for failure to timely file returns, failure to pay taxes shown on the return, and failure to pay estimated taxes were upheld. On its own motion, the court imposed a $10,000 frivolous argument penalty under § 6673 because of the taxpayer’s groundless arguments and unwarranted attempt to assert his Fifth Amendment privilege (“In order for an individual to validly claim the privilege against self-incrimination, there must be a ‘real and appreciable danger’ from ‘substantial hazards of self incrimination’, and the individual must have ‘reasonable cause to apprehend (such) danger from a direct answer to questions posed to him.’”), finding that he acted with the intent to delay collection of the taxes owed.

12. The whistleblower won the first skirmish but is likely be left whistling in the dark when the battle’s over. Lippolis v. Commissioner, 143 T.C. No. 20 (11/20/14). A whistleblower sought Tax Court review of a § 7623(a) 15 percent discretionary award with respect to $844,746 of tax collected as a result of an audit performed in response to his whistleblower claim. He argued that he was entitled to a greater (mandatory) award under § 7623(b). The IRS moved to dismiss for lack of jurisdiction on the ground that § 7623(b)(5)(B) provides that a mandatory award is not required unless the tax, penalties, and interest involved in the underlying audit exceeded $2 million. The Tax Court (Judge Colvin) held that the $2 million requirement is an affirmative defense and is not jurisdictional. Accordingly, the IRS’s motion was denied. But the IRS was given 60 days to file a motion for leave to amend the answer to raise the § 7623(b)(5)(B) affirmative defense and to include allegations of fact supporting the amendment to the answer.

13. The Tenth Circuit stirs the previously muddied water on whether a late-filed return is a "return" that will permit tax debt to be discharged in bankruptcy proceedings. In re Mallo, ___ F.3d ___, 114 A.F.T.R.2d 2014-7022 (10th Cir. 12/29/14). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a "return" within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers' federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

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

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

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

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a "return" because it does not satisfy "the requirements of applicable nonbankruptcy law (including applicable filing requirements)" within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a "return" within the meaning of 11 U.S.C. § 523(a).

- The Tenth Circuit's interpretation of 11 U.S.C. § 523(a) is contrary to the IRS's interpretation, which the IRS made clear to the court during the appeal. The IRS's interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that "section 523(a) does not provide that every tax for which a return was filed late is nondischargeable." However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) "is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not 'filed' within the meaning of section 523(a)(1)(B)(i)."

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. The story line is just a rerun: NOLs do not reduce self-employment income. DeCrescenzo v. Commissioner, T.C. Memo. 2012-51 (2/27/12). The taxpayer was assessed deficiencies when he failed to file a return of income from self-employment as an accountant. The Tax Court (Judge Marvel) held – yet again – that § 1402(a)(4) prohibits a taxpayer from offsetting net earnings from self-employment with an NOL carryforward or carryback.

a. And the Second Circuit sees it the same way. DeCrescenzo v. Commissioner, 563 Fed. Appx. 858 (2d Cir. 4/30/14). In a summary order, the Second Circuit affirmed and held that § 1402(a)(4) "expressly excludes net operating loss carryovers from the calculation of self-employment income."

2. Tax refunds in a bad economy set up another deference conflict among the circuits. In Re Quality Stores, Inc., 693 F.3d 605 (6th Cir. 9/7/12), *cert. granted*, 134 S. Ct. 49 (10/1/13). In November 2001 Quality Stores closed 63 stores and 9 distribution centers and terminated the employment of all employees in the course of Chapter 11 bankruptcy cases. Quality Stores adopted plans providing severance pay to terminated employees. The company reported the severance pay as wages for withholding and employment tax purposes then filed claims for refund of FICA and FUTA taxes claiming that the severance pay represented supplemental unemployment compensation benefits (SUBs) that are not wages for employment tax purposes. Disagreeing with the contrary holding by the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), the Sixth Circuit held that the SUBs were exempt from employment taxes. The court examined the language and legislative history of § 3402(o)(1), which provides that SUB payments "shall be treated *as if it were a payment of wages*" for withholding purposes, to conclude that by treating SUB payments as wages for withholding, Congress recognized that SUB payments were not otherwise subject to withholding because they did not constitute "wages." Then, under *Rowan Cos. v. United States*, 452 U.S. 247, 255 (1981), the court concluded that the term "wages" must carry the same meaning for withholding and employment tax purposes. Thus, if SUBs are not wages under the withholding provision (because they must be treated as wages by statutory directive), the SUBs are not wages for employment tax purposes. The court also rejected the IRS's position in Rev. Rul. 90-72, 1990-2 C.B. 211, that to be excluded from employment taxes SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit's holding in *CSX Corp.*, which adopted the eight part test of Rev. Rul. 90-72, stating that, "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories." The court also stated that it could not conclude that the opinion in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), eroded the holding of *Rowan Cos. v. United States*, which compelled the court to interpret the meaning of "wages" the same for withholding and employment tax purposes.

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

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

3. Final regulations on authorizing an agent to undertake employment tax obligations. T.D. 9649, Section 3504 Agent Employment Tax Liability, 78 F.R. 75471 (12/12/13). Final regulations include Federal Unemployment Tax Act (FUTA) withholding taxes within the scope of current regulatory authority that allows employers to meet their FICA tax obligations for domestic in-home services through an agent as provided in § 3504. The agent files a single return for multiple employers using the agent's employer identification number.

a. Rev. Proc. 2013-39, 2013-52 I.R.B. 830 (12/12/13). The IRS has described and updated procedures for filing Form 2678 for an employer of a provider of domestic in-home services to designate an agent under Reg. § 31.3504-1(a) to file employment taxes.

4. Final regulations define employment tax liabilities of payors designated by an employer to pay employment taxes. T.D. 9662, Designation of Payor to Perform Acts Required of an Employer, 79 F.R. 17860 (3/31/14). The Treasury and IRS have finalized, with minor changes, proposed amendments to regulations under § 3504 (REG-102966-10, Designation of Payor as Agent to Perform Acts Required of an Employer, 78 F.R. 6056 (1/29/13)). The final regulations provide that a person that pays wages or compensation to individuals who perform services for an employer pursuant to a service agreement "is designated [under § 3504] to perform the acts required of an employer with respect to the wages or compensation paid." The regulations refer to the employer under a service agreement as the "client." The payor and the employer both are subject to all provisions of law, including penalties, that apply to employers. The preamble to the proposed regulations indicated that consistent with the IRS position on administering the § 6672 trust fund penalty, the employment tax liability of an employer will be collected only once whether from the payor or the employer. A service agreement is an agreement pursuant to which the payor (1) asserts explicitly or implicitly that it is the employer of the individuals performing services for the client, (2) pays wages or compensation to the individuals for services they perform for the client, and (3) assumes responsibility to collect, report, and pay employment taxes with respect to the wages or compensation paid. A payor is not considered designated to perform the acts required of an employer under the regulations if the payor (1) reports employment taxes under the client's EIN, (2) is a common paymaster under §§ 3121(s) or 3231(i), (3) is itself the employer of a person performing services for a client (including both a common law employer and a statutory employer who has legal control over the payment of wages under § 3401(d)(1)), or (4) is treated as an employer under § 3121(a)(2)(A), which addresses, among other things, payments for sickness or accident disability. Like the proposed regulations, the final regulations contain several examples to illustrate their application. The "final regulations are effective for wages or compensation paid by a payor in quarters beginning on or after March 31, 2014."

5. The IRS's failure to send a determination by certified or registered mail gives the taxpayer an extended period of time to file for Tax Court review of worker classification. SECC Corp. v. Commissioner, 142 T.C. No. 12 (4/3/14). The taxpayer filed a petition under § 7436 seeking a determination of the proper classification of its workers for employment tax purposes. On April 15, 2011, the IRS mailed to the taxpayer a letter stating that the taxpayer's employment tax liabilities as determined by Appeals would be assessed. The letter was not sent by certified or registered mail. The taxpayer's petition was filed more than 90 days after the IRS sent the April 15, 2011, letter. The Tax Court (Judge Colvin) held that the Tax Court had jurisdiction and the petition was timely. He reasoned as follows. First, the April 15, 2011 letter was a determination by the IRS relating to the classification of workers for employment tax purposes. Thus, the Tax Court had jurisdiction. Second, because the IRS did not send the determination by certified or registered mail, the 90-day period for filing an action in the Tax Court provided in § 7436(b)(2) was inapplicable; the petition was timely. Both the IRS's and taxpayer's motions to dismiss for lack of jurisdiction were denied.

6. Bankrupt employer? Little chance the promised retirement benefits will be paid? It doesn't matter. This United Airlines pilot still owed FICA taxes on the present value of future retirement benefits he will never receive. Balestra v. United States, 113 A.F.T.R.2d 2014-2301 (Fed. Cl. 5/31/14). In 2004, the taxpayer retired from his position as a pilot with United Airlines and, pursuant to § 3121(v)(2), the present value of his future retirement benefits ($289,601) was included in his FICA base for the year of his retirement. Section 3121(v)(2) provides that amounts deferred under a nonqualified deferred compensation plan must be taken into account for FICA purposes as of the later of the time the services are performed or the time when there is no substantial risk of forfeiture of the right to such amounts. United Airlines entered bankruptcy proceedings in 2002 and its liability for the taxpayer's retirement benefits was ultimately discharged. The taxpayer received only $63,032 of the promised benefits. The taxpayer brought this action seeking a refund of the FICA taxes he paid (at the 1.45% rate for the Medicare portion of FICA) on the $226,569 of retirement benefits that he never received. The regulations issued under § 3121(v)(2), Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), prescribe the method of determining present value and provide that the present value of future retirement benefits

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

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

7. Disregarded entities are regarded for employment tax purposes, except when they are disregarded. T.D. 9670, Disregarded Entities; Religious and Family Member FICA and FUTA Exceptions; Indoor Tanning Services Excise Tax, 79 F.R. 36204 (6/26/14). The Treasury has finalized, without substantive change, temporary and proposed regulations issued in 2011 that extend the exemptions from FICA and FUTA taxes for members of certain religious faiths and for certain services performed for family members to services performed in the employ of disregarded entities. Several cases, sustaining the check-the-box regulations under *Chevron* deference, held that the sole owner of a disregarded entity was liable for the disregarded entity's employment taxes. See, e.g., *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007), and *McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007). In the face of these litigation successes, Treasury adopted Reg. § 301.7701-2(c)(2)(iv) to provide that a disregarded entity is treated as a corporation for employment tax purposes and related reporting requirements, thereby shifting the liability away from the owner. However, treating the entity as a corporate employer would eviscerate provisions that exempt certain employment among family members and employment among religious persons who believe that Social Security taxes are contrary to the teachings of the religion or sect. Thus, the final regulations, §§ 31.3121(b)(3)-1(d) and 31.3306(c)(5)-1(d) provide that a disregarded entity treated as a corporation for employment tax purposes will not be treated as the employer for purposes of §§ 3121(b)(3) and 3306(c)(5), which provide an exemption from employment taxes for certain services performed by and for parents, children and spouses. Final regulation § 31.3127-1(b) provides that a disregarded entity will not be treated as the employer for purposes of § 3127, which provides an exception from FICA taxes where both the employer and employee are members of a religion that opposes participation in Social Security. Under each of these provisions, for purposes of applying the exemptions only, the owner of the disregarded entity will be treated as the employer. Further, final regulation § 301.7701-2T(c)(2)(iv)(C)(1) provides that the owner of a disregarded entity remains subject to the backup withholding requirements of § 3406. The changes are effective for wages paid after 11/1/11, but taxpayers may apply the rules to wages paid on or after 1/1/09.

B. Self-employment Taxes

1. According to the Tax Court, "The self-employment tax provisions are construed broadly in favor of treating income as earnings from self-employment." Old McDonald had a farm and on his farm he collected federal subsidies that were self-employment income. Morehouse v. Commissioner, 140 T.C. No. 350 (6/18/13). In a reviewed opinion (15-0-0), the Tax Court (Judge Marvel) overruled its prior decision in *Wuebker v. Commissioner*, 110 T.C. 431 (1998), *rev'd*, 205 F.3d 897 (6th Cir. 2000), and held that payments under the U.S. Department of Agriculture (USDA) Conservation Reserve Program (CRP) are self-employment income subject to self-employment taxes. The taxpayer owned farm land in South Dakota, which he had rented to tenant farmers. The taxpayer entered into a CRP contract with the USDA under which in exchange for annual payments the taxpayer agreed to (1) maintain already established grass and legume cover for the life of the contract; (2) "[e]stablish perennial vegetative cover on land temporarily removed from agricultural production", including pubescent or intermediate wheatgrass, alfalfa, and sweet clover; and (3) engage in "pest control and pesticide management" for the life of the contract. The taxpayer hired a former tenant farmer to carry out most of the work, but the taxpayer supervised the operation, purchased materials needed to implement the conservation plans, gathered documentation necessary to the CRP payments, arranged for individuals to hunt on some of the properties, and visited the properties several times during the tax years involved. The court held that these activities were sufficient to constitute a trade or business carried on by the taxpayer the income from which was subject to self-employment taxes under § 1402(a)(1). The court indicated that regardless of whether the taxpayer's activities qualified as farming, the taxpayer was directly and through his agent "engaged in the business of participating in the CRP and that he enrolled, maintained, and managed multiple properties subject to CRP contracts with the primary intent of making a profit."

a. But according to the Eighth Circuit, "we embrace the agency's longstanding position that land conservation payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax." Morehouse v. Commissioner, 769 F.3d 616 (8th Cir. 10/10/14). In an opinion by Judge Beam (2-1), the Eighth Circuit reversed the Tax Court's decision and held that "land conservation payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax." The court relied on Rev. Rul. 60-32, 1960-1 C.B. 23, in which the IRS concluded that soil bank payments made to persons who did not operate or materially participate in a farming operation were "not to be included in determining net earnings from self-employment," although soil bank payments to farmers were to be treated as self-employment income derived from their farming business. The court noted that "[a]lthough Revenue Ruling 60-32 did not explain why the IRS differentiated between farmers and non-farmers, [Rev. Rul. 65-149, 1965-1 C.B. 434] indicated the IRS viewed soil bank payments to non-farmers as rental income.). The court accorded no deference to the proposed revenue ruling in Notice 2006-108, and it distinguished *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000), *rev'g*, 110 T.C. 431 (1998), as "seem[ing] to rest on its conclusion that, because the taxpayers' maintenance obligations under their CRP contracts were intrinsically similar to activities performed in their active farming operation–'tilling, seeding, fertilizing, and weed control'–these obligations did not rise to the level of 'occupancy or use' by the government." "While CRP contracts may require farmers to conduct a small subset of activities similar to those used in a portion of their general farming operations, *Wuebker*, 205 F.3d at 903, the same cannot be said for non-farmers. The only reason they even indirectly engage in or arrange for any "tilling, seeding, fertilizing, and weed control" activities on their CRP land is because the agreement with the government requires them to do so."

- Judge Gruender dissented. Even if he gave no deference to Notice 2006-108—particularly in light of the IRS's inconsistent positions—he agreed with its interpretation of the rentals-from-real-estate exclusion. "[E]ven according no deference to Notice 2006-108, I agree with its interpretation of the rentals-from-real-estate exclusion. Because the term 'rentals from real estate' is not defined in the Internal Revenue Code, it must be interpreted 'in accordance with its ordinary or normal meaning,' … with the qualification that, as an exclusion from net earnings from self-employment, the rentals-from-real-estate exclusion must be narrowly construed." The CRP payments were not "rent," because "Morehouse enjoyed uninterrupted and unfettered access to his property. Under these circumstances, it cannot be said that Morehouse's checklist of tasks along with the government's sporadic entries onto his property somehow translated into 'use' of Morehouse's property by the government."

C. Excise Taxes

1. Telephone excise tax trouble for the government ahead. Cohen v. United States, 578 F.3d 1 (D.C. Cir. 8/7/09) (2-1). In this telephone excise case, Judge Janice Rogers Brown's majority opinion held that the telephone excise tax challenge litigation violated neither (1) the Anti-Injunction Act, 26 U.S.C. § 7421(a), which provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed" nor (2) the Declaratory Judgment Act, 28 U.S.C. § 2201(a), which allows for declaratory relief but specifically excludes federal taxes from its reach, because (1) the standalone Administrative Procedure Act, 5 U.S.C. § 702, claim in the instant case is "the anomalous case where the wrongful assessment is not disputed and the litigants do not seek a refund," and (2) the Declaratory Judgment Act is coextensive with the Anti-Injunction Act (citing circuit precedent). Judge Brown began her opinion:

> Comic-strip writer Bob Thaves [creator of *Frank and Ernest* (1972)] famously quipped, "A fool and his money are soon parted. It takes creative tax laws for the rest." In this case it took the Internal Revenue Service's ("IRS" or "the Service") aggressive interpretation of the tax code to part millions of Americans with billions of dollars in excise tax collections. Even this remarkable feat did not end the IRS's creativity. When it finally conceded defeat on the legal front, the IRS got really inventive and developed a refund scheme under which almost half the funds remained unclaimed. Now the IRS seeks to avoid judicial review by insisting the notice [Notice 2006-50] it issued, acknowledging its error and announcing the refund process, is not a binding rule but only a general policy statement.

- Judge Brown stated that the IRS position was "just mean," and that it "places taxpayers in a virtual house of mirrors." She continued, "Despite the obvious infirmities of [the IRS position], the IRS still has the chutzpah to chide taxpayers for failing to intuit that neither the agency's express instructions nor the warning on its forms should be taken seriously."
- Judge Brown concluded, however, that "[a]ppellant Neiland Cohen filed his refund claim prematurely and, [we] thus, affirm the District Court's dismissal of his refund claim." The case was remanded to the District Court for its consideration of the merits.
- Judge Kavanaugh dissented, stating that the appellant could simply have followed the procedures of Notice 2006-50.
- The D.C. Circuit granted rehearing en banc, 3/11/10.

a. A case warning that tax professionals continue to ignore administrative law at their (clients'(?)) peril. The panel holding was upheld on rehearing en banc. Cohen v. United States, 650 F.3d 717 (D.C. Cir. 7/1/11) (6-3). In upholding its original panel decision to remand the case to the District Court for its consideration of the merits, Judge Brown wrote the majority opinion that held the suit was not precluded by either the Anti-Injunction Act or the Declaratory Judgment Act. Judge Kavanaugh's dissent emphasized that this suit was merely a prelude to a class action suit seeking monetary relief from the government, and that there was an adequate remedy in individual refund suits following claims for refund under the procedures of Notice 2006-50 in which all claims under the Administrative Procedure Act could be asserted.

- **Enough, already!" The IRS cries, "Uncle."** Notice 2006-50, 2006-1 C.B. 1141 (5/26/06), *revoking* Notice 2005-79, 2005-2 C.B. 952. The IRS announced that it will stop assessing the § 4251 telephone excise tax on long distance services, and that it will provide for refunds of taxes paid on services billed after 2/28/03 and before 8/1/06. These refunds are to be requested on 2006 Federal income tax returns, the right to which will be preserved by the IRS scheduling overassessments under § 6407. Individuals are eligible to receive a safe harbor amount, which has not yet been determined. Interest received on the refunds will have to be reported as 2007 income.

b. **On remand, the district court granted prospective vacatur of Notice 2006-50.** In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 853 F. Supp. 2d 138 (D. D.C. 4/10/12). The District Court (Judge Urbina) found Notice 2006-50 to have been improperly promulgated in violation of the Administrative Procedure Act, i.e., that it was a binding rule promulgated without notice and hearing. However, he dismissed two of the three complaints [Cohen and Gurrola plaintiffs] consolidated for pre-trial proceedings that failed to raise that ground, and permitted only one complaint [Sloan plaintiffs] to go forward. Judge Urbina granted relief on that third complaint by merely vacating that notice prospectively, i.e., he issued a prospective vacatur.

c. **The district court entered final judgment.** In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 901 F. Supp. 2d 1 (D. D.C. 10/29/12). The District Court (Chief Judge Lamberth, following Judge Urbina's retirement) entered final judgment in favor of the Sloan plaintiffs on their procedural APA claim and in favor of the government on all other claims of the three plaintiffs.

d. **In its divided panel decision following remand, the D.C. Circuit upheld the district court decision anticipatorily vacating Notice 2006-50 but approved of the IRS's failure to offer any further relief. Judge Rogers dissented in a vehement opinion blasting the IRS and the horse it rode in on.** In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, 751 F.3d 629 (D.C. Cir. 5/9/14), *petition for rehearing en banc denied*, 2014 U.S. App. LEXIS 12636 (7/2/14). The D.C. Circuit (Judge Randolph) affirmed the district court judgment, holding that the remand order to the IRS to permit it to correct mistakes in the issuance of Notice 2006-50 was an appealable decision.

- Judge Janice Rogers Brown dissented, stating:

> This is a complicated and frustrating case. It has lasted five years and accomplished nothing. In this litigation, the Internal Revenue Service (IRS) has lost every round, but, as the court's opinion confirms, the odds are always with the house.
>
> Round one was *Cohen I*, 578 F.3d 1, 388 U.S. App. D.C. 80 (D.C. Cir. 2009), where we determined the taxpayers could move forward with a challenge to Notice 2006-50. The Service, rocked but undaunted, tried again with a larger group of judges in *Cohen II*, 650 F.3d 717, 397 U.S. App. D.C. 33 (D.C. Cir. 2011) (en banc), arguing it was immune to suit outside the narrow confines of the refund process. Again, it failed—by split decision, the taxpayers won. On remand—round three—the district court found the IRS had violated the APA and vacated the offending notice, but it declined to set any timetable for further action.
>
> The Service announced the demise of the refund notice and resolutely refused to take any other remedial action. Though there is no dispute about the

unauthorized nature of the exaction, it intends to keep the unrefunded portions of its ill-gotten gains—a few billion dollars. Indeed, the Service fares better than the Las Vegas casinos: even when they lose, they win. Since no law "unequivocally" requires the IRS to do the right thing, they have the discretion to do wrong. The taxpayers are out of luck. It was not always thus. . . .

The Service's recalcitrance is disconcerting, and I do not share my colleagues' confidence that no law imposes a duty upon the Service to create a *workable* refund scheme. . . .

- She concluded:

Once upon a time, public law concerned itself with notions of what was morally right, not just what was minimally required. But, as counsel for the Service has repeatedly reminded us throughout this litigation, those days are part of the dim (and not to be recaptured) past. *See* Appellee's Br. at 37 ("After making the concession that limited the scope of 'toll telephone service' to which I.R.C. § 4252(b)(1) applied, the IRS was by no means required to notify every taxpayer potentially entitled to a refund, or even to publicize the availability of refunds."). These days, no matter how unwarranted its exactions, whether the Service returns anything to the taxpayers—when circumstances do not fit the usual paradigm—is a decision within its sole discretion. Following the Service's reasoning to its logical conclusion, the more larcenously it behaves, the lighter its obligations to plundered taxpayers become. No doubt this is a sign of the times, but it seems more an artifact of an administrative state gone deeply awry.

2. The medical devices excise tax sticks to the manufacturer. Chemence Medical Products, Inc. v. Medline Industries, Inc., 989 F. Supp. 2d 1349 (N.D. Ga. 12/4/13). In a declaratory relief action, the court held that the 2.3 percent tax on medical devices imposed under § 4191(a), enacted as part of the Affordable Care Act, falls on the manufacturer rather than the distributor. Before enactment of the ACA, Chemence Medical Products entered into a contract to supply adhesives to Medline, a distributor of medical supplies. Chemence sought declaratory relief that it could pass the tax onto the supplier as a price increase, notwithstanding the fact that price increases were limited under the agreement between Chemence and Medline. The court found that the language of § 4191 and Reg. § 48.4191-1(c) are clear that the incidence of the tax falls on the manufacturer when the manufacturer is taxable. The court rejected arguments by the manufacturer that language in the statute imposing the tax at the highest wholesale price, imposing the tax on distributors when the manufacturer, producer, or importer is "untaxable", or that pass-through provisions in the statute indicate the ultimate burden of the tax should fall on the entity that bears the tax permit shifting the tax from the manufacturer. The court also found that provisions in the sales agreement prohibited Chemence from passing the tax to Medline as a price increase.

3. The price of skin cancer is increased by the excise tax on tanning services. T.D. 9621, Indoor Tanning Services; Excise Tax, 78 F.R. 34874 (6/11/13). Final Regulations § 49.5000B-1 are promulgated for collection of the 10 percent excise tax on indoor tanning facilities under § 5000B enacted as part of the Affordable Health Care Act. The tax is imposed on amounts paid for indoor tanning services. The final regulations generally adopt provisions in the proposed and temporary regulations. The regulations include an exemption for Qualified Physical Fitness Facilities, the predominant business or activity of which is to serve as a physical fitness facility that does not charge separately for indoor tanning services available at the facility. For other purveyors of indoor tanning, the tax applies to amounts actually paid for indoor tanning services that are provided at a reduced rate. The tax does not apply to services that are obtained by redemption of points through a loyalty program. Where tanning services are bundled with other goods and services, the final regulations set out a formula to determine the amount reasonably attributable to indoor tanning services. With respect to gift cards, the tax is imposed when the card is redeemed specifically to pay for indoor tanning services and not when the card is purchased. The tax is also imposed on prepaid monthly membership and enrollment fees regardless of the services actually provided.

a. **The price of a tan goes up even in disregard of the hazard from which the owner is protected.** T.D. 9670, Disregarded Entities; Religious and Family Member FICA and FUTA Exceptions; Indoor Tanning Services Excise Tax, 79 F.R. 36204 (6/26/14). The Treasury has finalized, without substantive change, temporary and proposed regulations issued in 2012 that add the 10 percent excise tax on indoor tanning services of § 5000B to the list of excise taxes for which disregarded entities (QSub or single owner business entity) are treated as separate entities. These changes apply to taxes imposed on amounts paid on or after 7/1/12.

4. **The government prevails on the substantive issue whether an excise tax is due on S corporation shares held by an ESOP, but is barred from assessing the tax by the applicable period of limitations.** Law Office of John H. Eggersten P.C. v. Commissioner, 142 T.C. 110 (2/12/14). An ESOP owned all the stock of the taxpayer, a subchapter S corporation. Under the ESOP, 100 percent of the stock of the taxpayer was allocated to John H. Eggersten, the individual who formerly owned the stock. The government and the taxpayer agreed that Mr. Eggersten was a "disqualified person" within the meaning of § 409(p)(4). Because the ESOP allocated all the stock of the S corporation to Mr. Eggersten, the shares were deemed-owned shares with respect to him under § 409(p)(4)(C) and he was treated as owning them for purposes of § 409(p) and the related excise tax imposed by § 4979A. The government argued that, because disqualified persons owned 50 percent or more of the number of shares of employer securities consisting of stock of an S corporation, a non-allocation year had occurred in 2005 within the meaning of § 409(p)(3). Accordingly, the government argued, under § 4979A(a), an excise tax was imposed on the S corporation equal to 50 percent of the "amount involved." The government relied on a special rule in § 4979A(e)(2)(C), which provides that "the amount involved for the first nonallocation year of any employee stock ownership plan shall be determined by taking into account the total value of all the deemed-owned shares of all disqualified persons with respect to such plan." Thus, the government sought to impose a tax equal to 50 percent of the value of the S corporation's shares. The Tax Court (Judge Chiechi) agreed with the government that § 4979A(a) imposed the tax for tax year 2005, but concluded that the period of limitations in § 4979A(e)(2)(D) for assessing the tax had expired before the government issued its notice of deficiency. In its analysis of the imposition of the tax, the court rejected the taxpayer's argument that § 4979A(a) does not impose an excise tax when a non-allocation year occurs. The court also rejected the taxpayer's argument that the "first nonallocation year" specified by § 4979A(e)(2)(C) was 1999, the year in which Mr. Eggerston transferred the S corporation shares to the ESOP, rather than 2005. In reaching this conclusion, the court relied on the effective date of the relevant provisions, which apply to plan years beginning after 12/31/04. Under § 4979A(e)(2)(D), the period of limitations for assessing the excise tax is three years from the later of the allocation or ownership giving rise to the tax or the date on which the Secretary is notified of the allocation or ownership. Section 4979A(e)(2)(D) does not define the term "notified." Relying on its approach to a similar issue in *Stovall v. Commissioner*, 101 T.C. 140 (1993), the court looked for guidance to the regulations issued under § 1033(a), which specify that a notification must contain "all of the details." The court concluded that the S corporation's 2005 return on Form 1120S and the employee benefit plan 2005 return on Form 5500, both filed in 2006, provided the requisite notification. The period of limitations on assessment therefore expired in 2009. Because the IRS did not issue the notice of deficiency until 4/14/11, assessment of the tax was precluded.

XII. TAX LEGISLATION

A. Enacted

1. **This needs an Act of Congress?** H.R. 3458, the **Fallen Firefighters Assistance Tax Clarification Act of 2013**, P.L. 113-63 was signed by President Obama on 12/20/13. This Act exempts from income payments from public charities under §§ 509(a)(1) and (2) to firefighters [formerly, firemen] injured in a 12/24/12 ambush, or to the spouses or

dependents of firefighters who were killed, when responding to a fire in Webster, NY. Payments between 12/24/12 and 1/19/14 will qualify for the exemption.

2. **Would this Act better be called the Political Cowardice Tax Act of 2014?** The Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, colloquially called the "Extenders Bill," was signed by the President on 12/19/14. The Tax Increase Prevention Act retroactively extended through 12/31/14 a myriad of deductions, credits, and special benefit provisions that had expired at the end of 2013. It did not address extension of these provisions, or any other expired provisions, to 2015.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

For the State Bar of Texas—Tax Law in a Day

Commercializing and Protecting Intellectual Property in an Increasingly Open and Fluid World

by
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I. Intellectual Property Introduction. Intellectual property ("IP") generally describes the intangible property created by human intellect, and may include inventions, literary works, artistic works, logos, and designs, any of which may be used commercially by the owner. Federal law and many state laws grant certain exclusive rights in intellectual property and enforcement rights against those who use the IP without consent of the owner. The four major areas of IP discussed in this paper are copyrights, trademarks, patents, and trade secrets.

A. Copyrights. Protection of original works of authorship is provided under the Copyright Act, which protects any such works that are "fixed in any tangible medium of expression."[1] Examples of original works include the text of literary works such as articles, essays and books, paintings and illustrations, music and lyrics, photographs, choreography, and computer programs.[2] This federal copyright protection is provided immediately once the original work is "fixed" and does not require a federal registration with the Copyright Office.[3] Copyright protection confers the owner with the exclusive right to use, copy and distribute the original work in any medium and the right to make derivative works thereof along with the right to license any of these rights to a third party. The duration of protection and exclusive rights granted under the Copyright Act is limited to a finite period of time, and for an organization responsible for creating original works, the duration of the copyright protection is the earlier of 120 years from creation or 95 years from publication.[4]

B. Trademarks. Trademarks and service marks are words, designs, colors, symbols, sounds, or a combination of these used in association with goods or services and that identify a company or entity.[5] In the United States, common law rights in a trademark are usually obtained by the first party to use a mark for specific goods or services in a specific geographic area. This use provides the owner with the exclusive right to use the mark in that geographic region and can be perpetual there as long as the mark is in use and not abandoned. Trademark rights may be protected under both state and federal registrations; however, a registration with the U.S. Patent and Trademark Office generally provides the owner with exclusive rights to use the mark nationwide; whereas, state registrations are limited to exclusive rights and protection within a

[1] 17 U.S.C. § 102(a).
[2] *Id.*
[3] *Id.* § 304 (for works created on or after January 1, 1978).
[4] *Id*. § 302(a),(c).
[5] *Id*. § 1127.

state. In fact, the state registrations may also be preempted by a federal registration, and thus, may provide no more than common law rights established where the mark has been in use.[6]

If the mark is federally registered, in addition to use requirement to avoid abandonment of the mark, the owner must also make the requisite maintenance filings with the U.S. Patent and Trademark Office to preserve the registration. For example, after the fifth and no later than the sixth year of registration, the trademark owner must file a declaration of continued use along with a sample specimen of use.[7] In addition, a renewal application and specimen of use must be filed every ten years, beginning with the tenth year from the registration date.[8]

In addition to continued use of the mark, the owner has a duty to police the use of its mark by unauthorized parties to avoid a claim that the owner has abandoned rights in its mark. Even for authorized users who have been granted a license to use the owner's mark, the trademark owner must exercise some degree of control over the licensee so that the goods/services provided by the licensee under the mark meet the standards required by the trademark owner. By exercising the quality control standards for the licensee's goods and services, the trademark owner helps maintain the value and goodwill associated with its mark.

C. Patents. A patent is a right that is granted by the federal government for an invention that provides the inventor or owner of the patent with the right to exclude others from making, using, or selling the invention for a specific period of time in exchange for the public disclosure of the invention when the patent is granted as well as the right to license such rights during the period of patent protection.[9] Typically, inventions that are subject to patent protection are useful machines, processes, compositions (collectively "Utility Patents"), or ornamental designs ("Design Patents") or even new varieties of plants.[10] For patent applications filed since 1995, the term of a Utility Patent is twenty years from the application filing date. For design patents filed on or after December 18, 2013, the term is fifteen years from the date of issuance; for those filed before December 18, 2013, the term is fourteen years from issuance.[11]

D. Trade secrets. A trade secret is type of intellectual property that is comprised typically of any information, data, device, process, formula, or technique that is of economic value to a company or entity, that is not readily ascertainable by the public, and that the owner has undergone reasonable efforts to maintain its secrecy (including limiting the number of employees provided access to such).[12] The protection afforded trade secrets is governed by state law, but most states, including Texas, have adopted to the Uniform Trade Secrets Act to harmonize the standards governing the protection and remedies for misappropriation.[13] Examples of things that

[6] *See e.g*., Minute Man of Am., Inc. v. Coastal Rests., Inc., 391 F. Supp. 197, 198 (N.D. Tex. 1975) (noting that the Texas registration was limited to the area of use as against a federal registrant regardless when the federal registration occurs); HERBERT J. HAMMOND, TEXAS INTELLECTUAL PROPERTY LAW HANDBOOK 149-50 (2d ed. 2011).
[7] 15 U.S.C. § 1058.
[8] *Id*. §§ 1058, 1059.
[9] 35 U.S.C. §§ 112, 271(a).
[10] *Id.* §§ §§ 101, 161, 171.
[11] 35 U.S.C. §§ 154(a)(2), 173.
[12] *See* TEX. CIV. PRAC. & REM. CODE ANN. § 134A.002(6); *see also* Unif. Trade Secrets Act § 1.
[13] *See, e.g.*, TEX. CIV. PRAC. & REM. CODE ANN. § 134A.002(6); *see also* Unif. Trade Secrets Act § 1.

might be considered a trade secret for a non-profit organization include donor lists, financial data, and fundraising strategies.

II. How is intellectual property important to nonprofits? For all non-profit organizations, intellectual property is important whether it is intellectual property created by the organization or instead is intellectual property used by the organization in the operation of its business. The following are examples of areas in which intellectual property rights can be critical to a nonprofit entity:

- Branding and marketing
- Educational materials
- Brochures
- Discoveries/inventions made by the non-profit
- Fundraising and development activities
- Website content
- Social Media
- Software
- Vendors

III. Intellectual Property owned by the Nonprofit.

A. Marks and Branding. One of the most important forms of intellectual property of a non-profit organization may be its trade name. Along with the name, the organization may utilize a unique design and/or tag lines, all of which consumers would associate with the organization. Such name and/or logo would be considered a mark because it serves as a source identifier of the organization.

If the nonprofit organization provides services that reach beyond one state or to the extent that such would be considered use in interstate commerce, the organization should consider obtaining federal trademark protection for its brand and tag lines. The benefits of a federal trademark registration include the following: the presumption of nationwide exclusive rights to the use mark; the right to use the symbol ®; the right to sue for infringement in federal court; a presumption of validity of the mark; potentially enhanced remedies; constructive notice of a claim of ownership, and the right to keep other confusingly similar marks off of the federal trademark registry and even some state registries.[14] Even if the mark is not federally registered,

[14] 15 U.S.C. §§ 1111, 1115(a); Xtreme Lashes, LLC v. Xtended Beauty, Inc. 576 F.3d 221, 232 (5th Cir. 2009); Pebble Beach Co. v. Tour 18 I, Ltd., 155 F.3d 526, 533 n.4 (5th Cir. 1998).

federal law may still protect an unregistered mark from the use of a confusingly similar mark in the geographic use of the organization's mark.[15]

B. Original Works of Authorship. Essential to a nonprofit organization is its original works of authorship, whether they are development materials, educational materials, videos, website content, or other original works. As noted above, any original work of authorship fixed in a tangible medium is afforded copyright protection under the copyright Act.[16] Typically, an organization or company will own any such original work of authorship as a "work made for hire" if an employee of the organization has developed or created the work as a part of the scope of his or her employment.[17] The "work made for hire" doctrine applies to any work created by the employee in the scope of his or her employment.[18] Many companies and organizations include the concept of "work made for hire" in their employment policies to educate their employees on this issue even though it is not necessary for title to the copyright to vest in the name of the organization or company.

The more complicated issue arises when an employee creates a work that could be outside the scope of his or her employment. A few examples could include the following:

- A photograph taken by employee at a company picnic and published on the company website (when photography is not a component of the employee's job responsibilities);
- A company logo designed by an employee in a company contest allowing employees to submit a proposed logo to be voted on by all employees;
- Website content created by an employee whose normal job duties are related to finance and accounting; and
- An article written for a company newsletter by an employee as a contributor and not a part of the newsletter staff at the company.

If any of the above are activities outside of the employee's typical duties, it is possible that these works may not be owned by the organization as works made for hire, and instead may be works whose copyrights are owned by the employee (i.e., the original creator).[19] In such cases, to avoid any uncertainty regarding the copyright ownership of these works, the organization could have the employee assign to the organization any and all rights that he or she "has" or "may have" in the work. One way for obtaining such assignment would be to include a present assignment provision in the employment agreement, which would cause the assignment to be effective upon the creation of any work. Alternatively, the employment agreement could

[15] See 15 U.S.C. § 1125(a)(1)(A); Marathon Mfg. Co. v. Enerlite Prods. Corp., 767 F.2d 214, 217 (5th Cir. 1985).
[16] 17 U.S.C. § 102(a).
[17] *Id*. § 101.
[18] *Id*. § 101; *see also* Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 751-52 (1989) (noting that the following would be considered in determining whether the creator of the work is an employee: tax treatment; provision of benefits; work location; resources provided by employer; payment method; the hiring party's right to control the manner and means by which the work is accomplished; and the duration of the relationship between the parties).

require that the employee assign his or her rights in the work upon the employee's submission of any work to the organization.

Due to the potential volume of original works of authorship that could be owned by an non-profit organization or any company, it is likely unrealistic to assume that an entity would register all of its original works with the Copyright Office; however, all organizations should consider registering works that are vital or that add substantial value to the organization. The following may be examples of such works:

- Videos
- Development and fundraising strategies
- Books
- Promotional materials
- Educational materials, booklets
- Testing materials
- Workshop/seminar materials
- Music (original to the organization)
- Computer programs
- Collections of images

[19] *See* U.S. Auto Parts Network, Inc. v. Parts Geek, LLC 692 F.3d 1009, 1015 (9th Cir. 2012) (noting that "courts have accordingly adopted [the Restatement (2d) of Agency] section 228's three-prong test for determining when a work is made by an employee 'within the scope' of employment: '(a) it is of the kind [the employee] is employed to perform; (b) it occurs substantially within the authorized time and space limits; [and] (c) it is actuated, at least in part, by a purpose to serve the [employer]").

Registration is not required for copyright protection; however, a copyright registration prior to the infringement of a work will provide the copyright owner with a broader remedy—specifically, the copyright owner would have a right to choose statutory damages imposed by the court instead of relying on actual damages, which might be difficult for the court to calculate.[20]

As a deterrent to unauthorized copying as well as basis for claiming willful infringement, an entity should include a copyright notice on all materials. Such notice typically identifies the year of first publication and copyright owner, as shown below:

© 2015 ABC Foundation

No registration is required for the inclusion of the © notice symbol. In the copyright notice, an organization may also identify what rights, if any, a third party may have to use or reproduce the work. Such language could be added to the notice provision, as follows:

- © 2015 ABC Foundation. All rights reserved. No copies, reprints, or reproductions may be made without the express authorization of ABC Foundation.

or

- © 2015 ABC Foundation. All rights reserved. Reproductions and copies may be made for personal use only.

or

- © 2015 ABC Foundation. All rights reserved. Copies, reprints, or reproductions may be made by [insert limitations/restrictions].

C. Inventions and Discoveries. In the event that a non-profit entity is directly involved in scientific research, technological developments, and the like, patent protection may be available for such intellectual property.[21] As noted above, patent protection provides the patent owner with exclusive rights to prevent third parties from making, using or selling the patented invention but only for a limited period of time. In order for an inventor or owner of an invention to obtain an issued utility patent, the inventor is required to file the patent application within one year of the first public use of the invention.[22] Unlike the ownership of original works created by employees within the scope of their employment, which are considered works made for hire under the Copyright Act, inventions created by employees within the scope of employment are not solely owned by the employer. In fact, prior to the amendment of U.S. patent law by the America Invents Act of 2013, employee inventors were the owners of the inventions identified in patent applications. For such an organization to own the patent for an invention created by the organization's employee, regardless of whether the invention was made within the scope of the employee's job, the employee had to assign the ownership of the patent to his or her employer despite the fact that the invention was developed within the scope of employment. The America Invents Act has made it easier for employers/companies to own the patents for inventions developed by their employees by having the inventor-employee submit a declaration stating

[20] 17 U.S.C. § 412(1); *see also* 17 U.S.C. § 504.
[21] *See, e.g.*, 35 U.S.C. § 271.
[22] *Id.* § 102(b).

whether the inventor is under an obligation to assign the invention.[23] To the extent that the organization expects to own all rights in a patent, it should have the employee assign its rights to the organization, which assignment shall be filed with the U.S. patent and Trademark office.

IV. Special Issues.

A. Works created by independent contractors, consultants, and developers. A common misperception is that any work product created by a third-party on behalf of a company is owned by the company. Such third-party work product consists of website pages, custom software applications, photographs, training materials, architectural drawings, and the like. What is likely owned by the company is a copy of the work product provided to the organization but not the copyright for that work product. For example, an organization may hire a photographer to take photographs of images to be used on the organization's website as well as in marketing materials. The organization may be given the right to make unlimited copies of the photographs or it may have an implied right to use the photographs in any medium; however, the actual copyright ownership still remains with the photographer. In another example, the organization may have hired a software developer to create a custom program to be used in operation of the organization's business. The organization would not be able to make enhancements or other modifications to the program (i.e., derivative works) without assignment of all rights or without, a license granting the organization such specific rights.

The organization may not really care whether it has a perpetual license or full ownership in the copyright of any work product created on its behalf as long as it has a perpetual right to use and modify the work product. If it has invested huge sums in the development of the work product, the organization is more likely to seek full title to the copyright. If ownership in all intellectual property rights of such work product is desired, then the organization may want to consider including assignment clause in the services contract, transferring ownership either upon creation of the work product or upon payment in full for the services to develop the work product.

B. Affiliated organizations or local chapters. For an organization who has local chapters or affiliated organizations authorized to use the organization's intellectual property, such organization should consider having its local groups and affiliates enter into a license agreement to spell out the specific terms of use. With respect to the trademarks and logos, it is particularly important to include standards of use to avoid a claim of abandonment and also to help avoid damage to the organization's reputation by the affiliated party's use. In the event that the organization has many chapters or other potential sublicensees, having trademark use guidelines available online and easily accessible is a convenient way to provide use standards. Such guidelines could also specify how copyright-protected materials may be used.

C. Volunteers. Many nonprofit organizations engage the assistance of volunteers, especially in fundraising events and educational programs. It is not uncommon for a volunteer to create materials on behalf of the organization; however, it is likely that the intellectual property rights of such materials would be owned by the volunteer—not the organization. Arguably, without any agreement to the contrary, the organization likely has an implied license to use the materials

[23] *Id*. §§ 115, 118.

created on behalf of the organization for at least as long as the volunteer is involved with the organization, but such license could easily be revoked. To avoid the uncertainty associated with the organization's ability to use or continue use of the volunteer's materials, the organization should consider having all volunteers either assign his or her rights to the organization or grant a perpetual, irrevocable license to the organization. This could easily be accomplished by having the volunteer sign a simple release, which would include a disclaimer of any ownership rights in any materials created by the volunteer on behalf of the organization as well as a present assignment clause assigning to the organization ownership to the IP rights in the materials upon their creation. Alternatively, the volunteer could execute a simple license agreement granting a perpetual, royalty-free, irrevocable license to the organization.

- Example of a present assignment provision: "Volunteer acknowledges and agrees that all right, title and interest in and to original works of authorship created by Volunteer on behalf of Organization, including without limitation all copyrights thereof, shall be owned by Organization and upon creation of any such materials, Volunteer hereby assigns all right, title and interest that he/she has or may have in such materials to Organization."

- Example of a perpetual license provision: "Organization acknowledges that Volunteer owns all right, title and interest in and to original works created by Volunteer on behalf of Organization, including without limitation all copyrights thereof; however, Volunteer hereby grants to Organization a perpetual, irrevocable, royalty-free, nonexclusive, worldwide, license to use such materials and to make copies and derivative works thereof."

D. Domain names. It is common for entities, including nonprofit organizations, to own numerous domain names that ultimately resolve to the same website address for the entity. For example, ABC Foundation may acquire the following domain names <abcfoundation.org>, <abcfoundation.com>, <abcfoundation.net>, and <abcfoundationdallas.org> and have them all resolve to the same website. There is little policing performed by domain name registrars to prevent unauthorized parties from acquiring domain names that incorporate another party's trademark even though in their terms of use, most registrars require that the party obtaining a domain name represent and warrant that its registration will not directly or indirectly infringe the legal rights of a third party. This unauthorized use of an organization's mark may be an unintentional infringement and may occur, for example, when an affiliated entity of the non-profit organization or a local chapter registers a domain name that incorporates the entity's mark or trade name without that party having authorization to do so. Any rights granted to the affiliate or chapter related to the use of the parent organization's mark or trade name within a domain name should be addressed in the trademark use guidelines and/or license agreement with such third party.

A potentially more serious problem is the use of the organization's mark or trade name in a domain name by an unauthorized and unrelated party. Such use may constitute infringement if the domain name leads to an active website that either serves as a pay-per-click website with links to other commercial websites or serves as the website for a specific commercial enterprise.[24] The Anti-Cybersquatting Consumer Protection Act ("ACPA") may provide a claim under which the organization can stop this unauthorized use of its mark in a domain name;[25] however, instead of filing a lawsuit under the ACPA, another option for the organization would be to initiate a domain name dispute resolution proceeding.[26] Typically, these proceedings are trademark-owner friendly, provided that the trademark owner is able to show that the use and registration of the its mark the infringer is in bad faith. A dispute resolution proceeding generally involves the filing of a complaint with an arbitration body authorized for such proceedings, such as the National Arbitration Forum, and the submission of a response by the allegedly-infringing domain-name owner. Depending upon the arbitration entity, a supplemental submission may be allowed, but no discovery or other filings are required. A decision usually follows within two to three months of the infringer's response.

One "allowable" use of an organization's mark that can be particularly frustrating may occur when a third party incorporates into its domain name the organization's mark along additional words and together the mark and words are construed as free speech under the First Amendment. The following provides an example of the differences between an infringing use and a first amendment use:

> Example: In this example, ABC Foundation and XYZ are unrelated entities, and ABC Foundation is a well-known entity. XYZ's registration and use of the domain name <abcfoundation.org> that resolves to a website of XYZ Company may be infringement if there is no legitimate basis for XYZ Company's registration or use of the domain name incorporating the ABC Foundation name; however, a third party's registration and use of the domain name <abcfoundationsucks.com> that resolves to a website devoted to editorials about ABC Foundation may be protected as free speech.[27]

E. Website Issues. In addition to content, which would be considered intellectual property protected under the Copyright Act, there are other issues that organizations should address with respect to their websites.

1. Privacy Policy. Many nonprofit organizations collect information online, whether it be information from its members, donors, or other website users interacting with the website and regardless of whether such information is personally-identifiable information or nonpersonally identifiable, such as a cookie. Any business or entity that collects information through an online website should have a privacy policy, with a conspicuous link at least on the page in which

[24] *See, e.g.*, E. & J. Gallo Winery v. Spider Webs Ltd., 286 F.3d 270, 272-77 (5th Cir. 2002) (finding that the Anti-Cybersquatting statute directs a reviewing court to consider whether a defendant's bad faith intent to profit from the use of a mark held by another party in its domain name).

[25] 15 U.S.C. § 1125(d).

[26] *See, e.g., Uniform Domain-Name Dispute-Resolution Policy*, INTERNET CORPORATION FOR ASSIGNED NAMES AND NUMBERS (Oct. 24, 1999), available at https://www.icann.org/resources/pages/udrp-2012-02-25-en.

[27] *See, e.g.*, Taubman Co. v. Webfeats, 319 F.3d 770, 778 (6th Cir. 2003) ("We find that Mishkoff's use of Taubman's mark in the domain name "taubmansucks.com" is purely an exhibition of Free Speech, and the Lanham Act is not invoked. And although economic damage might be an intended effect of Mishkoff's expression, the First Amendment protects critical commentary when there is no confusion as to source, even when it involves the criticism of a business. Such use is not subject to scrutiny under the Lanham Act.") Note, however, that this decision does not take in to account a situation where factually untrue statements are made by the "sucks" site, which could be actionable.

information is collected. [28] Typically, state law governs the specific requirements for website privacy policies so these may vary from state to state; however, most require that the following be included:

- What information is collected;
- How the information is used;
- Whether the information is shared with third parties and if so, what is shared;
- An Internet user opt-out policy; and
- How the information is deleted.

Failing to implement a privacy policy could subject to the organization to penalties by the state attorneys general; however, an organization's failure to follow its own written policy may subject the organization to steep fines issued by the Federal Trade Commission as a breach of the Federal Trade Commission Act.[29]

2. Children's Online Privacy Protection Act ("COPPA"). For any organizations whose websites are directed at or may be directed at children and that collect information from children, the organization should comply with the regulations of COPPA.[30] Generally, COPPA requires prior parental consent for the collection of identifiable information by a website directed at children if the children are under age thirteen.[31] There are various methods of obtaining such consent, but there are also some actions that can be taken that help the website owner avoid liability.[32] One common way for a website to avoid having to meet the COPPA regulations is to have an online pre-registration procedure that prevents children under age thirteen from proceeding with registration.[33] Such pre-registration procedure might include requiring the Internet user to enter his or her birthdate, both the birthdate and current school grade, or some other age-identifying questions provided that the questions do not suggest the age threshold for being able to register with the site. Organizations who have websites that are or that might be directed at children but also who want to avoid issues with having to obtain parental consent will typically have pre-registration procedures to block children under age thirteen from registering.

3. Terms of Use.

a. Click-wrap vs. Browse-wrap. All websites, especially those that allow users to upload or submit content, should have terms of use. Websites should have a conspicuous link to the terms of use on the home page and also on the registration page, if applicable. For the websites that do not require the user to agree to the terms of use by clicking "I Agree" or "Yes"

[28] *See, e.g.*, CAL. BUS. & PROF. CODE §§ 22575-22578; CONN. GEN. STAT. § 42-471; UTAH CODE ANN. §§ 13-37-101, -102, -201, -202, -203; 201 MASS. CODE REGS. 17.00.
[29] 15 U.S.C. §§ 41-58.
[30] *Id*. §§ 6501-6506.
[31] *Id*. §§ 6501, 6502(a)(1).
[32] *Id*. § 6502(a)(2).
[33] *Id*. § 6503; 16 C.F.R § 312.11.

or some other form of active assent, such "browse wrap" agreements, the terms of use are typically not enforceable because the user has not had to affirmatively assent—i.e., has not had to click "I agree"—to the terms.[34] In contrast, however, "click wrap" agreements are typically enforceable because the user has affirmatively agreed to the terms of use after having had the opportunity to review them.

b. Digital Millennium Copyright Act Take-Down Provision. For any website that allows a third party to upload or submit content, the website owner/service provider should comply with the Digital Millennium Copyright Act ("DMCA") take-down provisions in order to avoid liability for copyright-infringement claims based on the content uploaded by a third party to the organization's website.[35] The DMCA take-down provision provides a safe harbor provided that the service provider:

- does not have actual knowledge that the material or an activity using the material on the system or network is infringing;
- in the absence of such actual knowledge, is not aware of facts or circumstances from which infringing activity is apparent;
- upon obtaining such knowledge or awareness, acts expeditiously to remove, or disable access to, the material;
- does not receive a financial benefit directly attributable to the infringing activity, in a case in which the service provider has the right and ability to control such activity;
- upon notification of claimed infringement as described in paragraph (3), responds expeditiously to remove, or disable access to, the material that is claimed to be infringing or to be the subject of infringing activity; and
- has designated an agent to receive notifications of claimed infringement by making available through its service, including on its website in a location accessible to the public, and by providing to the Copyright Office

The Register of Copyrights maintains a current directory of agents available to the public for inspection. [36]

In the event that an organization receives a DMCA notice of alleged copyright infringement on its website, the organization should immediately remove the allegedly infringing work, but the organization must also notify the party who posted or uploaded the content to that website and must allow that party to respond.[37] The failure of an organization to respond to a DMCA notice by refusing to take down the allegedly infringing content could make the organization liable for at contributory or induced infringement and liable potentially for direct infringement.[38] The DMCA further limits the liability of nonprofit educational institutions when

[34] *See, e.g generally*, Nguyen v. Barnes & Noble Inc., 763 F.3d 1171 (9th Cir. 2014) (affirming the district court's denial of Barnes & Noble's motion to compel arbitration, finding that Barnes & Noble's browse-wrap terms were unenforceable).
[35] 17 U.S.C. § 512.

an employee (faculty member or graduate student) uses the institutions' resources to obtain copyrighted material in performing a teaching or research function.[39] The institutions' liability is limited so long as:

- The employee's infringing activities do not involve providing online access to course materials that were required or recommended during the past three years;

- The institution has not received more than two notifications regarding the copyright infringement of that employee within the past three-year period; and

- The institution distributes information to all users regarding its compliance with all copyright laws.[40]

Even though take down notices may not be required for other forms of intellectual property infringement claims, many website owners have incorporated similar take down provisions for claims of trademark infringement and the infringement of other proprietary rights.

c. Representations and Warranties. Terms of use should also identify (i) prohibited uses of the website, (ii) representations and warranties of users, and (iii) indemnification provisions for a user's breach. Included in the representations and warranties should be those provisions in which the user represents and warrants that the copyright in any content submitted or uploaded by the user is owned by the user, or alternatively, that the user obtained a license or authorization to post or upload the content on the website. In addition, the user should represent and warrant that such content will not infringe the intellectual property of any third parties. A breach of either of these provisions could provide the organization with breach of contract rights, including the right to recover attorneys' fees. As additional protection, however, the website owner would likely want to include an indemnification clause to cover third-party claims that the uploaded content has infringed the intellectual property rights of a third party. In the event that the Internet user has no substantial assets, however, the organization may be at risk because the user may be considered "judgment proof" and may not be able to pay damages for a breach of warranty or to indemnify the organization.

F. Vendor agreements. Some nonprofit organizations may provide vendors or suppliers with the right to use the organization's name and/or logos on certain types of promotional materials, such as t-shirts, buttons, accessories, and materials used by chapters, affiliates, or other entities. Vendors should have a trademark license incorporated into the vendor agreements, and this license should be limited in time and to use on certain products. As noted above in Section I.B., it is important that the license have quality control provisions requiring the vendor to meet certain standards for the products manufactured and sold under the organization's marks. This license should also include provisions providing the organization with the right to inspect the products and pre-approve all uses of the mark. Failure to incorporate the quality control provisions into a vendor agreement could make it difficult for the organization to claim that it

[36] *Id*. § 512(c).
[37] *Id*. § 512 (c),(g).
[38] *See, e.g.*, Metro-Goldwyn Mayer Studios, Inc. v. Grokster, 545 U.S. 913, 935-37 (2005) (Grokster P2P service found liable for inducing copyright infringement for operating file sharing service.).
[39] 17 U.S.C. § 512(e).
[40] *Id*.

exercised the requisite control over the mark to avoid abandonment. Finally, the term of use of the organization's mark should be limited and may actually terminate upon the sell of all inventory bearing the licensed mark.

V. Unrelated Business Income Tax ("UBIT"): General Rules.[41] To the extent a nonprofit sells or licenses its IP to others, the nonprofit needs to consider whether the proceeds from the sale or license results in unrelated business income for the nonprofit.

A. Definition of Unrelated Business. Organizations described in Section 501(c)(3) of the Code[42] are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.[43] The term "unrelated trade or business" means an activity conducted by a tax-exempt organization which is regularly carried on[44] for the production of income from the sale of goods or performance of services[45] and which is not substantially related to the performance of the organization's charitable, educational or other exempt functions.[46]

1. Activity is a "Trade or Business." For purposes of the unrelated business income tax regime, "the term 'trade or business' has the same meaning it has in Section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."[47] Section 162 of the Code governs the deductibility of trade or business expenses. In that context, the U.S. Supreme Court has declared that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[48] When applying this test, the IRS may take into account a key purpose of the unrelated business income tax: to prevent unfair competition between taxable and tax-exempt entities. "[W]here an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations."[49]

The most important element as to whether the activity is a trade or business is the presence of a profit motive. In the context of a tax-exempt organization, the U.S. Supreme Court declared that the inquiry should be whether the activity "'was entered into with the dominant

[41] Portions of this discussion on unrelated business income are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).
[42] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[43] *See* I.R.C. § 511.

[44] Treas. Reg. § 1.513-1(a).

[45] I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).

[46] I.R.C. § 513(a).
[47] Treas. Reg. § 1.513-1(b).
[48] Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).
[49] Treas. Reg. § 1.513-1(b). *But see* La. Credit Union League v. United States, 693 F.2d 525, 542 (5th Cir. 1982) ("[T]he presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to be taxed.").

hope and intent of realizing a profit.'"[50] Significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.[51] When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive.[52] The mere fact that the activity is conducted as a fund-raising activity of the charity is not sufficient to conclude that the activity is not a trade or business.[53]

2. <u>Regularly Carried On Requirement</u>. In general, in determining whether a trade or business is "regularly carried on," one must consider the frequency and continuity with which the activities productive of income are conducted, and the manner in which they are pursued. Business activities are deemed to be "'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[54] For example, "[w]here income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business *[sic]*."[55] Similarly, "income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically."[56] However, "[w]here income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business."[57]

In making this determination, it is essential to identify the appropriate nonexempt commercial counterpart to the exempt organization's activity, because the manner in which the nonexempt commercial counterpart conducts its similar activities has an important bearing on whether the activity is considered to be carried on year-round, on a seasonal basis or intermittently. For example, a tax-exempt organization's annual Christmas card sales program was determined to be regularly carried on when conducted over several months during the holiday season because, although nonexempt organizations normally conduct the sale of greeting cards year-round, the Christmas card portion of the nonexempt organizations' sales was

[50] United States v. Am. Bar Endowment, 477 U.S. 105, 110, n. 1 (1986) (quoting Brannen v. Comm'r, 722 F.2d 695, 704 (11th Cir. 1984).
[51] Ill. Ass'n of Prof'l Ins. Agents v. Comm'r, 801 F.2d 987, 992 (7th Cir. 1986).
[52] *See, e.g.*, Carolinas Farm & Power Equip. Dealers Ass'n, Inc. v. United States, 699 F.2d 167, 170 (4th Cir. 1983) ("[T]here is no better objective measure of an organization's motive for conducting an activity than the ends it achieves."); La. Credit Union League v. United States, 693 F.2d 525, 533 (5th Cir. 1982) (finding that a profit motive existed based on the fact that the organization was extensively involved in endorsing and administering an insurance program that proved highly profitable); Fraternal Order of Police Ill. State Troopers Lodge No. 41 v. Comm'r, 87 T.C. 747, 756 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987) (reasoning that the organization's advertising activities were "obviously conducted with a profit motive" because the activities were highly lucrative and with no risk or expense to the organization).
[53] *See Am. Bar Endowment*, 477 U.S. at 115 (stating that a charity cannot escape taxation by characterizing an activity as fundraising, because otherwise "any exempt organization could engage in a tax-free business by 'giving away' its product in return for a 'contribution' equal to the market value of the product").
[54] Treas. Reg. § 1.513-1(c)(1).
[55] Treas. Reg. § 1.513-1(c)(2)(i).
[56] Treas. Reg. § 1.513-1(c)(2)(iii).
[57] Treas. Reg. § 1.513-1(c)(2)(i).

conducted over the same seasonal period.[58] By contrast, when an exempt organization's fundraising activities are conducted on an intermittent basis, such activities are generally considered not to be regularly carried on.[59]

Furthermore, in determining whether an exempt organization's business activities are "regularly carried on," the activities of the organization's agents may be taken into account.[60] Courts disagree as to whether an exempt organization's preparation time in organizing and developing an income-producing activity may be taken into account.[61]

3. Unrelated to the Charity's Exempt Purpose. In the event the charity's activities are determined to be regularly carried on, the next inquiry is whether such activities are related to the charity's purposes which constitute the basis for its exemption.[62] This in an inherently factual determination. To determine whether the business activity is "related," the relationship between the conduct of the business activities that generate the income and the accomplishment of the organization's exempt purposes must be examined to determine whether a causal relationship exists.[63] The activity will not be substantially related merely because the income produced from the activity is used to further the organization's exempt purposes.[64] Rather, the inquiry focuses on the manner in which the income is earned. Thus, a substantial causal relationship exists if the distribution of the goods from which the income is derived contributes importantly to the accomplishment of the organization's exempt purposes.[65] In each case, the determination of whether this relationship exists depends on the facts and circumstances involved. In making this determination, the size and extent of the activities involved are considered in relation to the nature and extent of the exempt functions they are serving.[66] If the activities are conducted on a

[58] Veterans of Foreign Wars, Dept. of Mich. v. Comm'r, 89 T.C. 7, 32-37 (1987).

[59] *See* Treas. Reg. § 1.513-1(c)(2)(iii) (stating fundraising activities lasting only a short period of time will generally not be regarded as regularly carried on, despite their recurrence or their manner of conduct); Suffolk County Patrolmen's Benevolent Ass'n, Inc. v. Comm'r, 77 T.C. 1314 (1981), *acq.*, 1984-2 C.B. 2 (determining that the conduct of an annual vaudeville show one weekend per year and the solicitation and publication of advertising in the related program guide which lasted eight to sixteen weeks per year was intermittent and not regularly carried on). *Cf*. Treas. Reg. § 1.513-1(c)(2)(ii) ("[E]xempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.")

[60] State Police Ass'n of Mass. v. Comm'r, 72 T.C.M. (CCH) 582 (1996), *aff'd*, 125 F.3d 1 (1st Cir. 1997).

[61] *See* Nat'l Collegiate Athletic Ass'n v. Comm'r, 92 T.C. 456 (1989) (finding that NCAA's sale of advertisements for annual championship program was "regularly carried on," in part because of the amount of preliminary time spent to solicit advertisements and prepare them for publication), *rev'd*, 914 F.2d 1417 (10th Cir. 1990) (holding that this activity was not regularly carried on, because only the time spent conducting the activity, not the time spent in preparations, is relevant to that determination); A.O.D. 1991-015 (indicating that the IRS will continue to litigate the issue).

[62] *See* Treas. Reg. § 1.513-1(d)(1).

[63] Treas. Reg. § 1.513-1(d)(1).

[64] I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(1).

[65] Treas. Reg. § 1.513-1(d)(2).

[66] *See* I.R.C. § 511.

scale larger than is reasonably necessary to accomplish the exempt purposes, the income attributed to the excess activities constitutes unrelated business income.[67]

B. Exceptions and Modifications. The term "unrelated trade or business" is subject to several exceptions under which certain businesses that may otherwise constitute unrelated businesses are removed from the scope of the tax. In particular, the term "unrelated trade or business" does not include a trade or business in which substantially all the work in carrying on the trade or business is performed for an organization without compensation.[68] Unlike the other exceptions, the "volunteer exception" is not restricted as to the nature of the businesses to which it pertains. In addition, the term "unrelated trade or business" does not include the trade or business of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.[69]

1. Passive Activities Generally. The purpose of the unrelated business income tax is to eliminate the conduct of unrelated businesses by tax exempt organizations as a source of unfair competition with for-profit companies. To the extent that income of a tax exempt organization is derived from investment and other passive activities, the taxation of such income is not necessary to accomplish this goal. Accordingly, the modifications to the unrelated business income tax exclude most passive income, as well as the deductions associated with such passive income, from the scope of the tax.[70] In particular, the following types of passive income are excluded from unrelated business taxable income:

i. dividends;[71]

ii. interest;[72]

iii. annuities;[73]

iv. payments with respect to securities loans;[74]

v. amounts received or accrued as consideration for entering into agreements to make loans;[75]

vi. royalties;[76]

67 *Id*.
68 I.R.C. § 513(a)(1).
69 I.R.C. § 513(a)(3).
70 *See generally* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).
71 I.R.C. § 512(b)(1).
72 I.R.C. § 512(b)(1).
73 I.R.C. § 512(b)(1).
74 I.R.C. § 512(b)(1). The term "payments with respect to securities loans," refers to income derived from a securities lending transaction in which an exempt organization loans securities from its portfolio to a broker in exchange for collateral. I.R.C. § 512(a)(5). Payments derived from a securities lending transaction typically include interest earned on the collateral and dividends or interest paid on the loaned securities while in the possession of the broker.
75 I.R.C. § 512(b)(1).

vii. gains or losses from the sale, exchange, or other disposition of property other than inventory;[77] and

viii. gains or losses recognized in connection with a charitable organization's investment activities from the lapse or termination of options to buy or sell securities or real property.[78]

2. Royalties. Because royalties are passive in nature, the receipt of royalty income by a tax-exempt organization does not result in unfair competition with taxable entities.[79] Accordingly, section 512 of the Code provides that a charity's UBTI generally does not include royalties.[80] A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name, or copyright.[81] The royalty may be in the form of a fixed fee or a percentage of sales of the products utilizing the charity's IP. In addition, the tax-exempt organization may retain the right to approve the use of its IP by the licensee without changing the determination that the income from the transaction is a royalty.

Of particular importance in the royalty context is the amount of services the charity performs in exchange for the payment received. In order to maintain the royalty exemption for the payments received, the charity may not perform more than *de minimis* services in connection with the arrangement.[82] If the charity performs more than insubstantial services, then the income received is considered compensation for personal services, the royalty exception would not apply, and the income would most likely be subject to tax as UBTI.[83]

For example, the Internal Revenue Service privately ruled that royalties received by a charity from the license of the charity's intellectual property to a for-profit company for use in the company's commercial activities were excluded from the charity's UBTI under the royalty exception.[84] Under the license agreement, the charity retained the right to review the designs and proposed uses of the charity's intellectual property, inspect the commercial counterpart's facilities where the product was manufactured, and inspect the commercial counterpart's books and records annually. The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were *de minimis*. Moreover, the licensing agreement was narrowly tailored to protect the charity's ownership of its intellectual property by giving the charity absolute discretion to reject proposed uses of the property, providing notice on every unit displaying the charity's mark that it was used with the charity's permission, and allowing the charity to approve and limit mass media advertising of the product.

[76] I.R.C. § 512(b)(2). A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name or copyright. Rev. Rul. 81-178, 1981-2 C.B. 135. By contrast, the payment for personal services does not constitute a royalty. *Id.*

[77] I.R.C. § 512(b)(5).

[78] I.R.C. § 512(b)(5).

[79] *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1533 (9th Cir. 1996).

[80] I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). A charity's UBTI would include royalties derived from debt-financed property. Treas. Reg. § 1.512(b)-1(b).

[81] Rev. Rul. 81-178, 1981-2 C.B. 135.

[82] *Sierra Club*, 86 F.3d at 1533–35.

[83] *See* Rev. Rul. 81-178.

[84] Priv. Ltr. Rul. 200601033 (Oct. 14, 2005).

The Internal Revenue Service concluded that the income that the charity would receive from the arrangement was "vastly out of proportion with the time and effort" the charity would expend. Therefore, it could only be compensation for the use of the charity's intellectual property.

The determination of the permissible amount of "insubstantial services" is uncertain, however, especially in connection with the charitable organization's exercise of quality control over the use of its IP by a licensee. As is prudent business practice, a charity would want to maintain quality control over the use of its IP by the licensee under the licensing agreement. In some cases, the Internal Revenue Service has determined that "mere" quality control does not constitute more than insubstantial services related to the royalty income.[85] In other cases, a charity's "quality control" was recharacterized as services, resulting in the income from the arrangement being taxed as compensation from services rather than exempted as royalty income.[86] Therefore, charities are left to struggle with the determination of the permissible types of "quality control" they can include in their licensing agreements without crossing the boundary between *de minimis* and substantial services.

Furthermore, caution should be taken in relying on the royalty exception for income received from the licensing of a charity's name or logo for placement on a commercial product. In evaluating the justification for the continued tax exemption for college athletic programs, the Congressional Budget Office recommended repealing the royalty exception to the extent that it applies to the licensing of a charity's name or logo:

> Some types of royalty income may reasonably be considered more commercial than others. . . . [W]hen colleges and universities license team names, mottoes, and other trademarks to for-profit businesses that supply apparel, accessories, and credit cards to the general public, they approve each product and use of their symbols and, in some cases, exchange information, such as donor lists, with the licensees to aid in their marketing. . . . The manufacture or sale of such items would clearly be commercial—and subject to the UBIT—if undertaken directly by the schools. Schools' active involvement in generating licensing income could be the basis for considering such income as commercial and therefore subject to the UBTI. . . .
>
> Bringing royalty income that accrues only to athletic departments under the UBIT would be problematic, however . . . . [I]f royalty income from licensing team names to for-profit businesses was truly considered commercial and subject to the UBIT, the same arguments would apply in full force to licensing all other university names and trademarks. A consistent policy would subject all such income to the UBIT because of its commercial nature. Such a change in policy could affect many other nonprofits in addition to colleges and universities . . . .[87]

C. <u>Public Disclosure of Information Relating to the Unrelated Business Income Tax</u>. Charitable organizations are required to make their annual Form 990/Form 990PF information returns and exemption materials available for public inspection.[88] Organizations that have unrelated business income also have to file a Form 990-T return. Charitable organizations

[85] *See, e.g.*, Rev. Rul. 81-178, 1981-2 C.B. 135; Priv. Ltr. Rul. 200601033 (Oct. 14, 2005); Priv. Ltr. Rul. 9029047 (Apr. 27, 1990)

[86] *See, e.g.*, NCAA v. Comm'r, 92 T.C. 456, 468–70 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990); Fraternal Order of Police v. Comm'r, 87 T.C. 747, 758 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987).

[87] CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS 13 (2009).

[88] I.R.C. § 6104(d)(1)(A).

described in Section 501(c)(3)[89] are required to make their Form 990-T returns[90] available for public inspection.[91] Certain information may be withheld by the charitable organization from public disclosure and inspection (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the charitable organization) *if* the Secretary determines that public disclosure of such information would adversely affect the charitable organization.[92] Under the commensurate in scope test, an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources.[93] However, if a substantial portion of the charity's income is from unrelated activities, the organization fails to qualify for exemption.[94]

D. Effect of Unrelated Business Activities on the Charity's Tax-Exempt Status. In order to obtain and maintain tax-exempt status, a charity must be operated primarily for the purposes described in Section 501(c)(3) of the Code. Accordingly, if a charity engages in too much unrelated business activity, it risks the loss of its tax-exempt status as no longer satisfying this operational test. There is no bright line rule with respect to how much unrelated business income a charity may receive without jeopardizing its tax-exempt status.[95] Whether an organization has a substantial non-exempt purpose is a question of fact.[96]

E. Use of Taxable Subsidiaries. If a charity engages in an activity that may produce substantial unrelated business income, the charity should consider conducting the activity through a taxable corporate subsidiary wholly owned by the charity. The taxable subsidiary will be responsible for paying income tax on the net taxable income from the activity. The net income may then be distributed to the charity in the form of dividends which generally are excluded from a charity's UBTI.

One advantage of this structure is that the activities of the taxable subsidiary normally will not be attributed to the charity. This is especially important if the conduct of the activity is so substantial that it may jeopardize the charity's tax-exemption. Second, the charity will not be required to file a Form 990-T related to the activity, which is available for public inspection. Although the taxable subsidiary will file a Form 1120, such form is not required to be made

[89] This requirement applies to all charitable organizations which file Form 990-T returns, regardless of whether such organizations are also required to file annual Form 990/Form 990PF information returns. However, state colleges and universities which are exempt from income tax solely under Section 115 of the Code are not required to make their Form 990-T returns available for public inspection. Notice 2007-45, 2007-22 I.R.B. 1320.

[90] An exact copy of the Form 990-T return, including all schedules, attachments and supporting documents must be disclosed. Notice 2007-45, 2007-22 I.R.B. 1320.

[91] I.R.C. § 6104(d)(1)(A)(ii).

[92] Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 330.

[93] Rev. Rul. 64-182, 1964-1 C.B. 186.

[94] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[95] In making this determination, courts may examine the amount of time or money spent on carrying out an unrelated trade or business. *See* Orange County Agricultural Society v. Comm'r, 893 F.2d 529 (2d Cir. 1990), *aff'g* 55 T.C.M. 1602 (1988) (denying exempt status where an organization received approximately one-third of its gross income from unrelated business activities).

[96] *See* Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945) (holding that the presence of a single, non-exempt purpose, if substantial in nature, will destroy exemption regardless of the number of importance of truly exempt purposes); B.S.W. Group v. Commissioner, 70 T.C. 352 (1978); Nationalist Movement v. Comm'r, 102 T.C. 558, 559 (1994), *aff'd,* 37 F.3d 216 (5th Cir. 1994).

publicly available. Third, use of a taxable subsidiary can protect the charity's assets from liabilities arising from the conduct of the unrelated business activity and isolate those liabilities to the taxable subsidiary. Finally, a taxable subsidiary can provide greater flexibility in structuring the unrelated business activity.

However, use of a taxable subsidiary may increase administrative burdens and costs of the charity. Additionally, the dividends from the taxable subsidiary may no longer be exempt from UBIT if the charity transfers debt-financed property to the taxable subsidiary.[97] If the charity provides administrative services to its taxable subsidiary for a fee, the IRS may reallocate income between the charity and the taxable subsidiary under Code section 482. Finally, if the charity receives interest, rent, annuity payments or royalties from its controlled taxable subsidiary, such payment may be treated as unrelated business income to the charity to the extent the payment reduces the trade or business income of the taxable subsidiary.[98]

VI. Application of Unrelated Business Income Tax to Cause-Related Marketing.[99] When a charity engages in a cause-related marketing alliance, the charity must carefully structure the alliance or the income the charity receives from the alliance may be treated as unrelated business income. Many cause-related marketing alliances involve recognition of the corporate partner's participation by the charity on its website and in print materials. Thus, this section first analyzes the possible application of the corporate sponsorship rules to cause-related marketing alliances. Cause-related marketing alliances also involve payment for the use of the charity's name, logo, or trademark; accordingly, this section next analyzes the application of the royalty exception to cause-related marketing alliances. Finally, because consumer perception of product endorsement by the charity might be considered as a factor in the UBTI analysis, this section analyzes whether the income received from cause-related marketing alliances could be included in UBTI as advertising income.

A. Corporate Sponsorship Rules in General. Under section 513(i) of the Internal Revenue Code, the receipt of qualified sponsorship payments by a charity does not constitute the receipt of income from an unrelated trade or business, and instead, the payment is treated as a charitable contribution to the charity.[100] A "qualified sponsorship payment" is "any payment[101] by any person engaged in a trade or business with respect to which there is no arrangement or

[97] I.R.C. § 357(c); Rev. Rul. 77-71, 1977-1 C.B. 155.

[98] I.R.C. § 512(b)(13).

[99] Portions of this discussion on cause-related marketing are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing,* 85 CHI-KENT L. REV. 883 (2010).

[100] I.R.C. § 513(i); Treas. Reg. § 1.513-4(a). The Treasury Regulations provide the following example of a qualified sponsorship payment:

> M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to the winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgement of the sponsorship.

Id. § 1.513-4(f), example 1.

[101] "Payment" means "the payment of money, transfer of property, or performance of services." *Id.* § 1.513-4(c)(1).

expectation that the person will receive any substantial return benefit."[102] A "substantial return benefit" is any benefit other than a "use or acknowledgement"[103] of the corporate sponsor and certain disregarded benefits.[104] Substantial benefits include the charitable organization's provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships;[105] and any license to use intangible assets of the charitable organization.[106] "If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment."[107] The exempt organization has the burden of establishing the fair market value of the substantial return benefit. If the organization fails to do so, "no portion of the payment constitutes a qualified sponsorship payment."[108]

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBIT principles.[109] The mere fact that the payments are received in connection with the corporate sponsor receiving a substantial return benefit does not necessitate the payments constituting UBTI. For example, in a memorandum released by the Internal Revenue Service in October 2001, examples of certain exclusive provider relationships were addressed.[110] Significantly, one example involved a contract between a soft drink company and a university, under which the soft drink company would be the exclusive provider of soft drinks on campus in return for an annual payment made to the university. Exclusive provider relationships are explicitly named as a substantial return benefit; therefore, the arrangement did not qualify as a qualified sponsorship payment. Because the soft drink company maintained the vending machines, there was no obligation by the university to perform any services on behalf of the soft drink company or to perform any services in connection with the contract. Accordingly, the university did not have the level of activity necessary to constitute a trade or business. Since the contract also provided that the soft drink company was given a license to market its products

[102] *Id*. For purposes of these rules, it is irrelevant whether the sponsored activity is temporary or permanent. *Id*

[103] The permitted "uses or acknowledgements" under the qualified sponsorship payment rules include (i) "logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company," (ii) "a list of the payor's locations, telephone numbers, or Internet address," (iii) "value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services," and (iv) "the payor's brand or trade names and product or service listings." *Id.* § 1.513-4(c)(1)(iv). "Logos or slogans that are an established part of the payor's identity are not considered to contain qualitative or comparative descriptions." *Id.*

[104] *Id.* § 1.513-4(c)(2). A benefit is disregarded if "the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than two percent of the amount of the payment." *Id.* § 1.513-4(c)(2)(ii). If this limit is exceeded, the entire benefit (and not just the amount exceeding the two percent threshold) provided to the payor is a substantial return benefit. *Id.*

[105] The Treasury Regulations define an "exclusive provider" relationship as any arrangement which "limits the sale, distribution, availability, or use of competing products, services or facilities in connection with an exempt organization's activity." *Id.* § 1.513-4(c)(2)(vi)(B). "For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit." *Id.*

[106] *Id.* § 1.513-4(c)(2)(iii)(D).

[107] *Id.* § 1.513-4(d).

[108] *Id.*

[109] *Id.* § 1.513-4(f).

[110] *See IRS Issues Field Memo on Exclusive Providers and UBIT*, 2001 TAX NOTES TODAY 192-26 (Oct. 3, 2001).

using the university's name and logo, the portion of the total payment attributable to the value of the license would be excluded from the university's UBTI as a royalty payment.

If the corporate sponsorship involves the charity's endorsement of the corporate sponsor's product or services, then the income from the corporate sponsorship will likely be included in the charity's UBTI as advertising income. "Advertising" is "any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product."[111] Advertising includes "messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product."[112] For example, the Internal Revenue Service considers the following messages to consist, at least in part, of advertising: (i) "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call at 555-1234. This station is proud to have the Music Shop as a sponsor,"[113] and (ii) "Visit the Music Shop today for the finest selection of music CDs and cassette tapes."[114] If a single message contains both advertising and an acknowledgement, the message is an advertisement. Where the Treasury Regulations do not allow one to clearly distinguish between advertisements and permitted uses and acknowledgements, a court may be inclined to take a common-sense approach and consider a message an advertisement if it "looks like" an ad.[115]

The United States Supreme Court considered whether advertising could be substantially related to an organization's exempt purposes in *United States v. American College of Physicians*,[116] the leading case on this topic. There, an exempt physicians' organization received income from the sale of advertising in its professional journal. The messages in question consisted of advertisements for "pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine." The organization "has a long-standing practice of accepting only advertisements containing information about the use of medical products, and screens proffered

[111] Treas. Reg. § 1.513-4(c)(v).

[112] *Id.* Typically, advertising is considered to be a trade or business that is unrelated to the charity's exempt purposes. Thus, the question remains whether the advertising activity is "regularly carried on." If advertising messages of a corporate sponsor's product are continuously present on the charity's website, such advertising activities would seem to be regularly carried on and the revenues therefrom would thus constitute UBTI. One counter-argument would appear to be that the limited number of advertisements makes the charity's activities dissimilar in extent to comparable commercial activities. *See* Tech. Adv. Mem. 9417003 (Dec. 31, 1993) (stating that an advertising campaign conducted by placing advertisements in programs for an organization's annual ball was not typical of commercial endeavors because solicitations for advertisements were limited in number and consisted of a single form letter). Given the variety and relative novelty of Internet advertisements, it would be unwise for a charity to rely upon such a position. *See generally* I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385 (announcing that the Internal Revenue Service was considering whether clarification was needed as to the application of the "regularly carried on" requirement to business activities conducted on the Internet).

[113] *Id.* § 1.513-4(f), example 7.

[114] *Id.* at example 8. Where a document can be broken down into segments identified in the Treasury Regulations, a court or the Internal Revenue Service will likely analyze each segment with reference to the rules set out above. *See, e.g.*, Tech. Adv. Mem. 9805001 (Oct. 7, 1997) (concluding that an "ad" did not rise to the level of advertising when it consisted of a can of a sponsor's pet food made to look like a trophy and included two slogans that had long been used by the sponsor in its advertising).

[115] *See, e.g.*, State Police Ass'n of Mass. v. Comm'r, 125 F.3d 1, 6 (1st Cir. 1997).

[116] 475 U.S. 834 (1986).

advertisements for accuracy and relevance to internal medicine." The organization argued that these advertisements were substantially related to its exempt functions because they contributed to the education of the journal's readers. At trial, experts testified that "drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture and use."[117] Rejecting the organization's claim and ruling that the advertising income was UBTI, the Supreme Court analyzed this issue as follows:

> [A]ll advertisements contain some information, and if a modicum of informative content were enough to supply the important contribution necessary to achieve tax exemption for commercial advertising, it would be the rare advertisement indeed that would fail to meet the test. Yet the statutory and regulatory scheme, even if not creating a *per se* rule *against* tax exemption, is clearly antagonistic to the concept of a *per se* rule *for* exemption . . . . Thus, the Claims Court properly directed its attention to the College's conduct of its advertising business, and it found the following pertinent facts:
>
>> The evidence is clear that plaintiff did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspect of the goods or services publicized. Those companies willing to pay for advertising space got it; others did not. Moreover, some of the advertising was for established drugs or devices and was repeated from one month to another, undermining the suggestion that the advertising was principally designed to alert readers of recent developments . . . . Some ads even concerned matters that had no conceivable relationship to the College's tax-exempt purposes.
>
> . . . This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury.[118]

B. Corporate sponsorship rules do not (fully) address the issue. The corporate sponsorship rules were enacted to address the situation where the charity uses the corporate sponsor's logo on the charity's materials. Cause-related marketing alliances typically involve the use of the charity's name or logo on the corporate partner's products. At first blush, the corporate sponsorship exception seemingly would not apply to cause-related marketing. However, cause-related marketing alliances often involve the charity's recognition of the alliance by acknowledging the corporate partner on the charity's website or print materials. Therefore, a charity may claim that at least a portion of the payment received is a "sponsorship payment" and attempt to treat that portion separately from the other revenue received from the cause-related marketing alliance. In particular, this may be the case where the alliance guarantees the charity a

[117] *Id.* at 847.

[118] *Id.* at 848–50 (citation omitted). Several cases and rulings follow the reasoning of *American College of Physicians*. *See, e.g.,* Minn. Holstein-Frisian Breeders Ass'n v. Comm'r, 64 T.C.M. (CCH) 1319 (1992) (holding that advertisements that may have been of "incidental benefit to breeders in running their day-to-day operations" but that did not "contribute importantly to improving the quality of the breed of Holstein-Friesian cattle" were not substantially related to a cattle breeding organization's exempt purposes); Fla. Trucking Ass'n v. Comm'r, 87 T.C. 1039 (1986) (holding that advertisements of products of particular interest to the trucking industry did not bear a substantial relationship to the exempt functions of a trucking trade association); Rev. Rul. 82-139, 1982-2 C.B. 108 (concluding that a bar association's publication of advertisements for products and services used by the legal profession was not substantially related to the association's exempt purposes).

minimum "contribution" from the corporate partner from the sale of the promotional merchandise.

In order for a sponsorship payment received by a charity to be excluded from the charity's UBTI as a qualified sponsorship payment, the affiliation cannot provide a substantial return benefit to the corporate partner.[119] Since cause-related marketing alliances grant the corporate partner a license to use the charity's name and logo on the product, such a right would be a substantial return benefit.[120] Nonetheless, the portion, if any, of the payment that exceeds the fair market value of the license to use the charity's name or logo may still be a qualified sponsorship payment.[121]

In conjunction with the corporate partner's use of the charity's name or logo, the charity may acknowledge the affiliation on the charity's website or printed materials. Depending on how the charity describes its affiliation with the corporate partner, the "use or acknowledgement" exception may not apply. The display of the logos and/or slogans of the corporate partners are "uses or acknowledgements." The provision of hyperlinks to various sponsors' Internet sites also constitutes merely "uses or acknowledgements," provided the sponsor's Internet site does not contain additional statements indicating that the charity promotes the sponsor or its products or services.[122] However, the provision of the hyperlink to the sponsor's website by the charity may be for the purpose of encouraging consumers to purchase the merchandise from the sponsor because the proceeds from those sales benefit the charity. Since the corporate sponsorship rules were not designed with cause-related marketing activities in mind, they do not address whether the charity's motivation in providing the link to the partner's website should be taken into account in determining whether the charity is promoting the sponsor's products or services.

C. Use of the charity's name or logo may (or may not) fit within the royalty exception. Based on the success of taxpayers in establishing royalty treatment for payments for the use of the charity's name and logo in the affinity card context,[123] it would seem that the payments received by a charity for the licensing of their name, logo, and trademarks in connection with the sale of the merchandise by the corporate partner should also be considered royalties and thus exempt from the charity's UBTI. This result presupposes that the charity is not performing more than an insubstantial amount of services in connection with the licensing of the charity's name, logo, and trademarks. If the charity performs more than insubstantial services, then the income

[119] *See* Treas. Reg. § 1.513-4(c)(1).
[120] A "substantial return benefit" is any benefit other than a "use or acknowledgement" of the corporate sponsor. Treas. Reg. § 1.513-4(c)(2). Importantly, substantial benefits include any license to use intangible assets of the charitable organization. Treas. Reg. § 1.513-4(c)(2)(iii).
[121] Treas. Reg. § 1.513-4(c)(2)(iv).
[122] Treas. Reg. § 1.513-4(f), examples 11 & 12; Priv. Ltr. Rul. 200303062 (Oct. 22, 2002).
[123] *See, e.g.*, Or. State Univ. Alumni Ass'n v. Comm'r, 193 F.3d 1098 (9th Cir. 1999); Common Cause v. Comm'r, 112 T.C. 332 (1999); Sierra Club, Inc. v. Comm'r, 77 T.C.M. (CCH) 1569 (1999); Miss. State Univ. Alumni, Inc. v. Comm'r, 74 T.C.M. (CCH) 458 (1997). Generally, an affinity credit card arrangement provides that a credit card company may use the exempt organization's name in connection with a credit card, and the organization will receive a certain percentage, or "royalty," from the income generated by the credit card. Based on such cases, the Internal Revenue Manual now indicates that the Internal Revenue Service will consider payments under affinity credit card arrangements royalties as long as only minimal services are provided by the exempt organization's members or employees. *See* I.R.S., INTERNAL REVENUE MANUAL § 7.27.6.7.3 (CCH 1999).

received is considered compensation for personal services, the royalty exception would not apply, and the income would most likely be subject to tax as UBTI.[124]

However, the law is not clear that the use of the charity's name or logo on the corporate partner's products fits within the royalty exception. If the charity's name or logo is placed on the corporate partner's product, the payment could instead be viewed as received in connection with the joint advertisement of the product.[125] Especially relevant in this analysis is consumer perception of apparent endorsement of the product by the charity because the charity has allowed its name and logo to be placed on the product without qualification. Although the licensing agreement and official position of the charity may state that the charity does not endorse the product, the charity normally retains the right to approve how its name and logo are used on the product. By approving the placement of its name and logo on the product, the charity may be held to the reasonable impressions such cause-related marketing leaves in the minds of consumers. If the charity's name and logo are used in such a way as to give consumers the impression that the charity endorses the product, the charity may be deemed to have endorsed the product. If the Internal Revenue Service looks beyond the explicit terms of the agreement to the manner in which the agreement is carried out, the payment may be considered advertising income received by the charity and may no longer be excluded from the charity's UBTI.

D. Revenue from cause-related marketing may be advertising. Both the courts and the Internal Revenue Service generally consider the publication and distribution of advertising by a charity to be unrelated to the accomplishment of the charity's exempt purposes.[126] If the charity conducts advertising activities on a regular basis, then the advertising income generally is taxable as unrelated business income.

Generally, displaying the charity's name or logo on the advertisement likely would not be sufficient to cause the advertising to be substantially related to the charity's exempt purposes. Although there are no rulings or other primary authorities considering receipts from advertisements bearing an exempt organization's name or logo, the Internal Revenue Service has considered receipts from the direct sale of items bearing an exempt organization's name or logo. If the inclusion of the charity's name or logo on items directly sold by the charity would not prevent receipts from constituting UBTI, then *a fortiori*, there is little reason to suppose that receipts from advertisements of a third party's products or services which contain the charity's name or logo would not constitute UBTI. However, as discussed above, the Internal Revenue Service has on occasion reached a contrary conclusion regarding the sale of t-shirts and similar items bearing an organization's name or symbol, where additional facts demonstrated how the items furthered the organization's exempt function. If such additional facts are present—for example, if the items advertised displayed the charity's message—this would be a positive

[124] *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1532 (9th Cir. 1996).
[125] Whether the placement of a charity's name or logo on a corporate partner's product is a joint advertisement is a fact specific determination. In some cases, the association between the charity's mission and the corporate partner's product is such that it would be clear the charity is not impliedly endorsing the corporate partner's product. In other cases, the charity's mission and the corporate partner's product are so closely aligned that it is unclear whether the charity endorses the corporate partner's product. The issue is prevalent because the most successful cause-related marketing alliances occur when the charity's mission and corporate partner's products are closely aligned.
[126] *See, e.g.*, Treas. Reg. § 1.513-1(d)(iv), example 7; United States v. Am. College of Physicians , 475 U.S. 834 (1986).

factor. Note, though, that the positive rulings would still not be directly applicable to receipts obtained from a sponsor for advertising a product. One would need to closely examine all of the facts and circumstances to determine the extent to which the advertising activity promoted the charity's message (as opposed to promoting the corporate partner more generally), with unpredictable results.

VII. Participation in Joint Ventures. Charitable organizations may partner with other charitable organizations or with for-profit organizations to produce or market an invention or copyrighted work. Participation in these joint ventures affords charitable organizations with numerous opportunities, such as to (1) further their exempt purposes, (2) diversify their revenue source, and (3) obtain needed capital or expertise in an increasingly competitive economic environment.[127] While these types of business arrangements can be highly profitable and truly beneficial to both the charitable and for-profit organizations involved, there is a serious risk for the participating charitable organization. The failure of the charitable organization to protect its charitable assets can lead the loss its federal tax exemption.

A charitable organization may not confer a "private benefit" on persons who are not within the charitable class of persons who are intended to benefit from the organization's operations, unless the private benefit is purely incidental. The purpose of the private benefit limitation is to ensure that charitable organizations are operated for public purposes because of their special tax status.[128] The determination of whether the private benefit is more than incidental is based on a "balancing test" set forth in a 1987 General Counsel Memorandum:

> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.[129]

If an organization provides more than incidental private benefit, the organization's tax-exempt status may be revoked.[130]

[127] *See generally* Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L. J. 21 (2005).
[128] *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). According to the Treasury Regulations, an organization does not qualify for exemption

> unless it serves a public rather than a private interest. Thus . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Id.
[129] I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (citations omitted). The Internal Revenue Service's balancing test was adopted by the Tax Court in *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).
[130] For example, the Internal Revenue Service ruled that an organization formed to promote interest in classical music was not exempt because its only method of achieving its goal was to support a commercial radio station that was in financial difficulty. Rev. Rul. 76-206, 1976-1 C.B. 154.

Prior to 1982, a charitable organization automatically ceased to qualify as tax exempt under Code Section 501(c)(3) when it served as a general partner in a partnership that included private investors as limited partners. The IRS's reasoning was that the obligations of the charitable general partner to its for-profit limited partners were incompatible with its requirement to operate exclusively for charitable purposes. The IRS's per se opposition to charitable organizations' involvement in joint ventures with for-profit investors was abandoned, however, in 1982, with the issuance of the *Plumstead Theatre Society* decision.

A. Plumstead Theatre Society v. Commissioner. In *Plumstead*, the Ninth Circuit Court of Appeals held that a charitable organization's participation as a general partner in a limited partnership involving private investors did not jeopardize its tax exempt status.[131] The theatre company at question co-produced a play as one of its charitable activities. Prior to the opening of the play, the theatre company encountered financial difficulties in raising its share of costs.[132] In order to meet its funding obligations, the theatre company formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. The IRS denied tax-exempt status to the theatre company on the grounds that it was not operated exclusively for charitable purposes. Based on the safeguards contained in the limited partnership agreement, which served to insulate the theatre company from potential conflicts with its exempt purposes, the Ninth Circuit Court of Appeals disagreed with the IRS, holding that the theatre company *was* operated exclusively for charitable (and educational) purposes, and therefore was entitled to tax exemption. One of the significant factors supporting the court's holding was its finding that the limited partners had no control over the theatre company's operations or over the management of the partnership.[133] Another significant factor was that the theatre company was not obligated for the return of any capital contribution made by the limited partners from the theatre company's own funds.[134]

Following its defeat in this landmark court decision, the IRS abandoned its prior per se opposition and formulated the basis on which charitable organizations could become general partners in joint ventures without violating the terms of their exemption.

B. The IRS's Two-Part Test for Joint Ventures. Soon after *Plumstead*, the IRS issued General Counsel Memoranda 39005 in which it set forth the required analysis in testing a charitable organization's participation as a general partner in a limited partnership involving private investors. The IRS used a two-prong "close scrutiny" test to determine the permissibility of joint venture arrangements between charitable and for-profit organizations. The IRS reiterated that participation by a charitable organization as a general partner in a limited partnership with private investors would not per se endanger its tax exempt status.[135] However, close scrutiny would be necessary to ensure that the obligations of the charitable organization as general partner do not conflict with its ability to pursue exclusively charitable goals.[136]

[131] Plumstead Theatre Society v. Comm'r, 675 F.2d 244 (9th Cir. 1982) *aff'g* 74 T.C. 1324 (1980).
[132] *Id*.
[133] Priv. Ltr. Rul. 200502046 (Oct. 18, 2004).
[134] *Id*.
[135] Gen. Couns. Mem. 39005 (June 28, 1983).
[136] *Id*.

> Thus, in all partnership cases, the initial focus should be on whether the joint venture organization furthers a charitable purpose. Once charitability is established, the partnership agreement itself should be examined to see whether the arrangement permits the exempt party to act exclusively in furtherance of the purposes for which exemption is granted, and not for the benefit of the limited partners.[137]

The foregoing required a finding that the benefits received by the limited partners are incidental to the public purposes served by the partnership.[138]

In other words, the two-pronged "close scrutiny" test requires that: (1) the activities of the joint venture further the charitable purposes of the charitable organization; and (2) the structure of the venture insulate the charitable organization from potential conflicts between its charitable purposes and its joint venture obligations, and minimizes the likelihood that the arrangement will generate private benefit. If the charitable organization fails to satisfy either test and the activities of the joint venture are substantial, the IRS may seek to revoke the charitable organization's tax exemption.

C. <u>Control by the Charitable Organization is a Key Factor</u>. In evaluating joint ventures between charitable organizations and for-profit organizations, the focus of the IRS in applying the two-pronged close scrutiny test eventually evolved into a "facts-and-circumstances" determination. This determination focused on whether the charitable organization retained sufficient control over the joint venture activities, thereby ensuring that the organization's own charitable purposes were furthered or accomplished through its participation in the joint venture and no more than incidental benefit, financial or otherwise, was conferred on the for-profit participants.

1. <u>Revenue Ruling 98-15</u>. Revenue Ruling 98-15 was the first guidance with precedential value promulgated by the IRS with respect to joint ventures between charitable organizations and for-profit entities.[139] The ruling incorporates the two-part close scrutiny test set forth in General Counsel Memorandum 39005 with a focus on whether charitable organizations "control" the ventures in which they participate.[140] The IRS saw the charitable organization's control of the venture as crucial because it provided the charitable organization with an ability to ensure that the venture's activities were exclusively in furtherance of the charitable organization's exempt purposes and served as a safeguard against too much benefit, financial or otherwise, being conferred on the for-profit participants.

Revenue Ruling 98-15 describes two scenarios: one "good" and one "bad" joint venture involving nonprofit and for-profit healthcare organizations.[141] The IRS scrutinizes a variety of factors that determine whether the nonprofit has sufficient control over the venture.[142] Although Revenue Ruling 98-15 lists a number of relevant factors, four factors appear to be most

[137] *Id*.
[138] *Id*.
[139] Rev. Rul. 98-15, 1998-1 C.B. 17.
[140] *Id*.
[141] Rev. Rul. 98-15, 1998-1 C.B. 17.
[142] *Id*.

significant: (1) governance control of the joint venture; (2) control of day-to-day operations of the joint venture; (3) management of conflicts of interest between the tax-exempt and for-profit participants; and (4) priority of charitable purposes over profit motives in the joint venture operations.

Based on substantial scrutiny of Revenue Ruling 98-15 after its release, several conclusions can be drawn. First, charitable organizations may participate in a joint venture with private investors and not automatically jeopardize their tax-exempt status. Second, in such situations, the joint venture agreement should clearly provide that the charitable partner's charitable purposes supersede any financial or private concerns in the event of a conflict between those goals. In addition, all contracts and agreements between the joint venture and another for-profit entity, such as a management agreement, must be entered into at arm's length and reflect commercially reasonable terms. Finally, Revenue Ruling 98-15 clearly favors the control of the joint venture's governing body by the charitable organization and elevates this component to unprecedented importance.[143]

2. Redlands Surgical Services v. Commissioner. In *Redlands*, the Tax Court upheld the IRS's denial of tax exempt status to a charitable organization which formed a joint venture with for-profit organizations.[144] In arriving at its decision that private, rather than charitable, interests were being served, the court examined various factors similar to the factors the IRS enunciated in Revenue Ruling 98-15.[145] The court noted, most significantly, that there was a lack of any express or implied obligation of the for-profit parties to place charitable objectives ahead of for-profit objectives.[146] Moreover, the relevant organizational documents did not include an overriding charitable purpose.[147] The Tax Court held that the requirement that a charitable organization operate exclusively for charitable purposes is not satisfied merely by establishing "whatever charitable benefits [the partnership] may produce," finding that the charitable partner lacked "formal or informal control sufficient to ensure furtherance of charitable purposes."[148] Affirming the Tax Court, the Ninth Circuit Court of Appeals held that ceding "effective control" of partnership activities impermissibly serves private interests.[149] *Redlands* provides that a charitable organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, "so long as the charitable organization does not thereby impermissibly serve private interests."[150]

3. St. David's Health Care System v. United States. The issue of whether a charitable organization's participation in a joint venture with for-profit participants would cause loss of the charitable organization's tax exempt status was revisited in *St. David's*, a case tried right here in Austin. Relying on Revenue Ruling 98-15 and *Redlands*, the Fifth Circuit Court of Appeals focused on the issue of the charitable organization's control over the joint venture, ultimately concluding that genuine issues of material fact existed with respect to whether the charitable

[143] *See generally* Mirkay, *supra* note 127.
[144] Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).
[145] *Id*.
[146] *Id*.
[147] *Id*.
[148] *Id*.
[149] 242 F.3d 904 (9th Cir. 2001).
[150] Rev. Rul. 2004-51, 2004-1 C.B. 974 (quoting Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999))

organization "ceded control" of its tax-exempt hospital.[151] The court held that the determination of whether a charitable organization that enters into a partnership with for-profit partners operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services."[152] The charitable partner also must have the "capacity to ensure that the partnership's operations further charitable purposes."[153] Thus, "the [charity] should lose its tax-exempt status if it cedes control to the for-profit entity."[154] The Fifth Circuit ultimately wanted to see majority control by the charitable organization. The IRS continues to view its position on control of the joint venture by the charitable organization, as supported by the *St. David's* decision, as the "proper framework" for analyzing joint ventures between charitable organizations and for-profit entities.[155]

4. Revenue Ruling 2004-51. Revenue Ruling 2004-51 is the first instance in which the IRS acknowledges and supports equal ownership by charitable and for-profit participants in a joint venture, provided some protections are in place to ensure the furtherance of the charitable organization's exempt purposes.[156] The ruling pointedly looks at which partner controls the exempt activities. If the charitable partner controls the exempt activities, the joint venture presumably will not endanger the tax exemption of the charitable organization. Specifically, Revenue Ruling 2004-51 involved an exempt university that formed a limited liability company with a for-profit entity to provide distance learning via interactive video. Ownership of the joint venture was split equally between the university and the for-profit partner, but the university controlled the academic portion of the joint venture's activities, while the for-profit partner provided and controlled production expertise. The ruling concluded that the university's exempt status was not affected by the joint venture because the activities constituted an insubstantial part of the university's activities.[157] The ruling also implies that fifty-fifty control of the joint venture is acceptable as long as the charitable partner controls the charitable aspects of the joint venture.[158]

Even though Revenue Ruling 2004-51 marks an indisputable movement forward in the IRS's stance regarding the proper federal income tax treatment of joint ventures between charitable organizations and for-profit organizations, the ruling stops short of answering all of the questions and issues raised by venturers. In particular, Revenue Ruling 2004-51 does not modify Revenue Ruling 98-15. Therefore, the control requirement set forth in Revenue Ruling 98-15 is still viewed as essential by the IRS, continuing to raise questions as to how and when it may be applied.

[151] St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003).
[152] *Id*. at 243.
[153] *Id*.
[154] *Id*. at 239.
[155] *Id*.
[156] Rev. Rul. 2004-51, 2004-1 C.B. 974.
[157] *Id*.
[158] *Id*. Revenue Ruling 2004-51 further stated that the limited liability company's activities would not generate unrelated business income for the university because (1) the university had exclusive control over the educational content, (2) all contracts entered into by the limited liability company were at arms length and for fair market value, (3) allocations and distributions were proportional to each member's ownership interest, (4) the video courses covered the same content as the university's traditional classes, and (5) the video courses increased access to the university's educational programs. *Id*.

D. UBIT Treatment for a Charity Investing in a Joint Venture. When a charity invests in a joint venture, the potential UBIT treatment of the investment to the charity will depend on the form of the investment. For example, if the investment is structured as a loan from the charity to the joint venture, then the interest that the charity receives on the loan generally will be excluded from the charity's unrelated business income as passive interest income.[159] Similarly, if the joint venture is formed as a corporation,[160] and the charity's investment in the joint venture is structured as the acquisition of shares of stock in the corporation, then the dividend distributions the charity receives from the corporation generally will be excluded from the charity's unrelated business income as passive dividend income.[161] These interest and dividend exclusions may not apply, however, to the extent the interest or dividend income is treated as unrelated debt-financed income.[162]

However, joint ventures are generally are treated as a partnership for federal income tax purposes. Accordingly, the joint venture does not pay income tax on its net earnings. Rather, the profits and losses of the joint venture are allocated to its members, each of whom report and pay tax on the allocated profits and losses in accordance with such member's own tax status.[163] For example, if a charity invests in a joint venture that is formed as a partnership, the charity would be required to report its allocated items of profit and loss from the joint venture on the charity's Form 990.

To the extent the reported items of income do not qualify for the passive exclusions from the unrelated business income tax (e.g., royalties, rents, and capital gains),[164] then the charity typically must apply the general three-prong UBIT test to determine whether the income from the business operated by the joint venture is unrelated business income for the charity.[165] Usually, investment in the joint venture will easily meet the first two prongs: the activity conducted by the joint venture typically is a trade or business and normally the activity is regularly carried on. Thus, the key determinant is whether the activity conducted by the joint venture substantially furthers the charitable purposes for which the charitable investor was granted tax-exemption. This is a case by case determination. Accordingly, a charity desiring to invest in a joint venture that is treated as a partnership for tax purposes must be careful to structure the joint venture to conduct activities which are closely aligned with the charity's own mission.

VIII. Compensation to Employees. If a nonprofit assigns its rights to IP produced by an employee to the employee, then careful consideration should be taken to ensure that the assignment of the IP rights does not produce unreasonable compensation to the employee.

[159] *See* I.R.C. § 512(b)(1); *but see* I.R.C. § 512(b)(13)(A)for an exception for certain interest payments received from a controlled subsidiary.
[160] The result is different if the corporation is treated as an S corporation for federal income tax purposes. All income distributable to a charitable S corporation shareholder is treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business. I.R.C. § 512(e).
[161] *See* I.R.C. § 512(b)(1).
[162] *See generally* I.R.C. § 514.
[163] *See id.* at 624.
[164] *See* I.R.C. § 512(b). If the joint venture derives the passive income from debt-financed property, then such income may be included in the charitable investor's unrelated business income as debt-financed income.
[165] *See* I.R.C. § 513.

Similarly, if the nonprofit and the employee share the rights to the IP, the employee's share of revenues produced from licensing the IP needs to be taken into account in determining whether the employee receives unreasonable compensation. Additionally, if the employee is a "disqualified person" with respect the nonprofit, the nonprofit will need to consider and approve the employee's total compensation package, including the value of the rights retained by the employee, in accordance with the rebuttable presumption procedures described below.

A. Excess Benefit Transactions Generally. Section 4958 of the Code imposes an excise tax on disqualified persons who engage in excess benefit transactions with public charities. An "excess benefit transaction" is any transaction in which an economic benefit is provided by the public charity directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received in exchange for such benefit.[166] The term "transaction" is used very generally and includes a disqualified person's use of a charitable organization's property and services provided to a disqualified person without adequate payment. Prototypical examples of excess benefit transactions include paying excessive compensation to a director or officer or overpaying a director or officer for property the director or officer sells to the charitable organization. However, any direct or indirect benefit to a disqualified person may result in a violation of Section 4958 if the disqualified person does not provide adequate consideration for the benefit.

When it applies, Section 4958 imposes an initial tax equal to 25% of the excess benefit on any disqualified person. [167] A tax of 10% of the excess benefit is imposed on any organization manager, i.e., any officer, director, or trustee of the organization, who knowingly participates in the transaction.[168] The initial excise tax on organization managers is capped at $20,000.[169] If a disqualified person engages in an excess benefit transaction with a public charity, corrective action must be taken to essentially undo the excess benefit to the extent possible and to take any additional measures to put the public charity in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[170]

The term "disqualified person" includes any person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization.[171] Some persons, including (but not limited to) board members, the president or chief executive officer, the treasurer or chief financial officer, family members of such individuals, and entities in which such individuals own 35% of the interests, are automatically considered "disqualified."[172]

Where a person is not *automatically* disqualified, all of the facts and circumstances will generally be considered to determine if the person has substantial influence over the affairs of the

[166] I.R.C. § 4958(c)(1).
[167] I.R.C. § 4958(f)(1).
[168] I.R.C. § 4958(a)(2).
[169] I.R.C. § 4958 (d)(2).
[170] I.R.C. § 4958(f)(6). The Treasury Regulations contain specific procedures to correct certain excess benefit transactions between a public charity and a disqualified person. See Treas. Reg. § 53.4958-7.
[171] I.R.C. § 4958(f)(1).
[172] Treas. Reg. § 53.4958-3(c).

organization.[173] Factors tending to show that an individual exercises substantial influence include:

i. the individual is a founder of the organization;
ii. the individual is a substantial contributor to the organization;
iii. the individual's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the individual controls;
iv. the individual has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees;
v. the individual manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or
vi. the individual owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.[174]

Factors tending to show that an individual does not exercise substantial influence include:

i. the individual has taken a bona fide vow of poverty as an employee, agent, or on behalf, of a religious organization;
ii. the individual is a contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the individual will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered);
iii. the direct supervisor of the individual is not a disqualified person;
iv. the individual does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole; or
v. any preferential treatment the individual receives based on the size of that individual's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.[175]

1. Exception for Non-Highly Compensated Employees. Nonetheless, an employee who does not receive economic benefits from the organization in excess of the indexed amount for being considered a highly compensated employee ($120,000 in 2015),[176] is not a disqualified person even if the above factors indicate that the individual may have substantial influence over

[173] Treas. Reg. § 53.4958-3(e).
[174] Treas. Reg. § 53.4958-3(e)(2).
[175] Treas. Reg. § 53.4958-3(e)(3).
[176] Notice 2014-70, 2014-48 I.R.B. 905 (Nov. 21, 2014). Note that this is a different standard than the one used to determine which individuals are "highly-compensated employees" for Form 990 reporting purposes.

the affairs of the organization.[177] This exception does not apply to employees who are automatically considered disqualified or who are substantial contributors to the organization.[178]

2. Initial Contract Exception. The theory behind the initial contract exception is that an individual who negotiates an employment agreement in good faith before the individual is in a position to exercise substantial influence over the organization should not be subject to sanctions even if the compensation under the employment agreement turns out to be excessive. Accordingly, Section 4958 does not apply to any fixed payment made to an individual with respect to an initial contract, regardless of whether the payment would otherwise constitute an excess benefit.[179] An "initial contract" is a binding written agreement between the charitable organization and an individual who was not a disqualified person immediately before entering into the agreement.[180] A "fixed payment" an amount of cash or other property specified in the agreement, or determined by a specified objective fixed formula, which is to be paid or transferred in exchange for the provision of specified services or property.[181] A fixed formula may incorporate an amount that depends on future specified events or contingencies (such as the amount of revenues generated by one or more activities of the organization), provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment.[182] If an initial contract provides for both fixed and non-fixed payments, the fixed payments will not be subject to Section 4958 while the non-fixed payments will be evaluated under an excess benefit transaction analysis, taking into account the individual's entire compensation package.[183]

B. What Constitutes Compensation? A disqualified person's entire compensation package must be evaluated to determine whether on the whole, the compensation received by the individual is reasonable for the services provided. Accordingly, if the organization is relying on the rebuttable presumption of reasonableness, the organization's board of directors must consider and approve the disqualified person's entire compensation package, not merely salary and bonuses. The compensation package includes all forms of cash and noncash compensation, all forms of deferred compensation if earned and vested, most fringe benefits whether or not taxable, employer-paid premiums for liability insurance coverage,[184] expense allowances and reimbursements, and other economic benefits received by the disqualified person from the organization in exchange for the performance of services.[185] However, the following benefits may be disregarded in evaluating the compensation package under Section 4958: (i) employee fringe benefits that are excluded from gross income under Section 132; (ii) expense reimbursements paid pursuant to an accountable plan; (iii) economic benefits provided to a

177 Treas. Reg. § 53.4958-3(d)(3).
178 *Id*.
179 Treas. Reg. § 53.4958-4(a)(3)(i).
180 Treas. Reg. § 53.4958-4(a)(3)(iii).
181 Treas. Reg. § 53.4958-4(a)(3)(ii).
182 *Id.*
183 Treas. Reg. § 53.4958-4(a)(3)(vi).
184 A charitable organization's payment of premiums for liability insurance covering Section 4958 excise taxes or indemnification of such taxes will not be an excess benefit if the premium or indemnification is included in the disqualified person's compensation when paid and the disqualified person's total compensation is reasonable. Treas. Reg. § 53.4958-4(b)(1)(B)(2).
185 Treas. Reg. § 53.4958-4(b)(1)(B).

disqualified person solely as a member of or volunteer for the organization if the same benefit is available to the general public in exchange for a membership fee of no more than $75 per year; and (iv) economic benefits provided to a disqualified person solely as a member of a charitable class that the organization is organized to serve.[186]

1. Determination of Reasonable Compensation. In general, the value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation). Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under Treasury Regulation Section 53.4958-4(a)(4)) provided to a person and the rate at which any deferred compensation accrues.[187] The factors generally considered for purposes of Section 162 include (i) the employee's qualifications, (ii) the nature, extent and scope of the employee's work, (iii) the size and complexities of the employer's business, (iv) the prevailing economic conditions, (v) the prevailing rates of compensation for comparable positions in comparable employers, and (vi) the employer's salary policy that applies to all employees.[188] The fact that bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. The fact that a state or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is *not* determinative of the reasonableness of compensation for purposes of Section 4958.[189]

Normally, the facts and circumstances to be taken into consideration in determining reasonableness of a fixed payment are those existing on the date the parties enter into the agreement pursuant to which the payment is made.[190] However, in the event of substantial non-performance, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. In the case of any payment that is not a fixed payment under an agreement, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment.[191]

2. Substantiation of Economic Benefit Treated as Compensation. To monitor disguised compensation, the Treasury Regulations require a charitable organization to clearly indicate its intent to treat an economic benefit as compensation when it is paid. This rule is intended to prevent a charitable organization from later claiming that an excess benefit transaction, such as a below-market loan or personal expense allowance, was actually compensation and that the overall compensation package of the disqualified person was reasonable.[192] To establish its intent, the organization must provide contemporaneous written substantiation of the economic

[186] Treas. Reg. § 53.4958-4(a)(4).
[187] Treas. Reg. § 53.4958-4(b)(1)(ii).
[188] Mayson Manufacturing Co. v. Comm'r, 178 F.2d 115 (6th Cir. 1949).
[189] Treas. Reg. § 53.4958-4(b)(1)(ii).
[190] These general timing rules also apply to property subject to a substantial risk of forfeiture. Therefore, if the property subject to a substantial risk of forfeiture satisfies the definition of fixed payment, reasonableness is determined at the time the parties enter into the agreement providing for the transfer of the property. Treas. Reg. § 53.4958-4(b)(2)(i).
[191] Treas. Reg. § 53.4958-4(b)(2)(i).
[192] *See, e.g.,* Treas. Reg. § 53.4958-4(c)(4) Example 2.

benefit intended to be compensation for services.[193] Contemporaneous written substantiation can be accomplished through the inclusion of the economic benefit on the individual's Form W-2 or Form 1099, through a written employment agreement, or through the written contemporaneous documentation of the approved compensation package under the rebuttable presumption of reasonableness.[194] However, the organization is not required to provide written substantiation of its intent to include nontaxable economic benefits, such as employer-provided medical insurance or employer contributions to a qualified retirement plan, as part of the individual's compensation.[195] As a result, even though contributions to qualified retirement plans and other nontaxable benefits are required to be taken into account in evaluating whether the overall compensation package is reasonable, they are not subject to the contemporaneous written substantiation requirement.

3. Revenue-sharing Compensation Arrangements. Revenue-sharing arrangements between a charitable organization and a disqualified person may be treated as an excess benefit transaction if the transaction results in prohibited private inurement.[196] The scope of this rule is uncertain and is not addressed in the final regulations. However, the implications of this rule may be significant for performance-based compensation arrangements and more complex arrangements to share revenue from intellectual property or other income-producing activities.

After the enactment of Section 4958, proposed regulations were issued that addressed the application of the excess benefit transaction rules to revenue-sharing compensation arrangements. These rules were not incorporated into the final regulations, and the Internal Revenue Service may later issue guidance in this area. In the meantime, revenue-sharing compensation arrangements are evaluated under the general rules governing reasonableness of compensation paid to a disqualified person, leaving a fog of uncertainty about whether these arrangements are in fact reasonable.

Since the old proposed regulations provide the only guidance on this issue, they are discussed herein for informational purposes, although they have no precedential value. In general, whether a revenue-sharing arrangement constitutes an excess benefit transaction depends on all relevant facts and circumstances. The arrangement may result in excess benefit if it permits a disqualified person to receive additional compensation without providing proportional benefits for the charitable organization. Relevant factors include the relationship between the size of the benefit provided and the quality and quantity of the services provided, and the ability of the disqualified person to control the activities generating the revenues.[197] The proposed regulations provided three examples illustrating the principles for determining whether a revenue-sharing transaction resulted in an excess benefit:[198]

i. In the first example, the disqualified person was an in-house investment manager for the charitable organization. In addition to the individual's regular salary and benefits, the

[193] Treas. Reg. § 53.4958-4(c)(1).
[194] Treas. Reg. § 53.4958-4(c)(3).
[195] Treas. Reg. § 53.4958-4(c)(2).
[196] I.R.C. § 4958(c)(4).
[197] Prop. Treas. Reg. § 53.4958-5(a) (withdrawn).
[198] Prop. Treas. Reg. § 53.4958-5(d) (withdrawn).

individual was entitled to a bonus equal to a percentage of any increase in the net value of the portfolio. The bonus was considered an incentive to maximize benefits and minimize expenses to the organization. Thus, even though the individual had a measure of control over the portfolio performance, the bonus produced a proportional benefit for the organization. Therefore, the revenue-sharing arrangement was not considered an excess benefit transaction.

ii. In the second example, the disqualified person was a third-party management company managing the charitable organization's charitable gaming activities. The management company controlled all of the activities generating revenues and paid the charitable organization a percentage of the net profits from these activities. Since the management company provided all the personnel and equipment for the activities, the management company controlled all the costs charged to revenues and net revenues. This structure did not provide the management company with an appropriate incentive to maximize benefits and minimize costs to the charitable organizations because the management company benefitted whether the net revenues were low because expenses were high or net revenues were high because expenses were low. In contrast, the charitable organization only benefitted if the net revenues were high. As a result, the entire transaction was considered an excess benefit transaction.

iii. In the third example, the disqualified person was a university professor who was the principal investigator in charge of certain scientific research. In addition to the professor's regular salary and benefits, the professor was entitled to a specified percentage of any patent royalties on inventions produced by the professor's research. This arrangement provided an incentive for the professor to produce especially high quality work and no incentive to act contrary to the university's interest. Moreover, the university shared proportionately with the professor. Lastly, the university owned and controlled the patent and the professor had no control over the revenues generated from the patent. This arrangement was not considered an excess benefit transaction. Many research institutions have invention and research policies similar to this example.

C. Rebuttable Presumption of Reasonableness. The Treasury regulations provide for a procedure, which if followed, creates a rebuttable presumption that a transaction between a public charity and a disqualified person will not constitute an excess benefit transaction within the meaning of Section 4958 of the Code. These procedures apply to fixed payments and, with minor additional requirements, to non-fixed payments subject to a cap.[199] Legislative history indicates that compensation arrangement or other financial transactions will be presumed to be reasonable if the transaction arrangement was approved in advance by an independent board (or an independent committee of the board) that (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person, (2) obtained and relied upon appropriate data as to comparability, and (3) adequately documented the basis for its determination.[200] The Treasury Regulations read into the legislative history three distinct requirements: (1) approval by an authorized body, (2) the appropriate data as to comparability, and (3) the documentation.[201]

[199] Non-fixed payments to a disqualified person not subject to a cap are generally not advisable.
[200] H.R. Rep. No. 104-506, at 56-57.
[201] Treas. Reg. § 53.4958-6(a)(1)-(3).

1. Approval by an Authorized Body. The authorized body may be the Board of Directors or a committee duly authorized under state law to act on behalf of the Board of Directors.[202] A person is not considered part of the authorized body if he merely meets to provide information to the board and then recuses himself.[203] No person voting on the matter may have a conflict of interest with respect to the transaction.[204] A member of the authorized body does not have a conflict of interest if the member:

i. is not the disqualified person or related to any disqualified person who benefits from the transaction;
ii. is not employed by or controlled by any disqualified person benefiting from the transaction;
iii. is not receiving compensation or other payments from a disqualified person benefiting from the transaction;
iv. has no material financial interest affected by the compensation arrangement or transaction; and
v. does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.[205]

2. Appropriate Data as to Comparability. The authorized body must have sufficient information to determine whether a compensation arrangement or other transaction will result in the payment of reasonable compensation or a transaction for fair value. Relevant information includes, but is not limited to:

i. compensation levels paid by other similarly-situated organizations (taxable or tax-exempt);
ii. availability of similar services in the applicable geographic area;
iii. independent compensation surveys;
iv. written offers from similar institutions competing for the services of the person;
v. independent appraisals of all property to be transferred; or
vi. offers for property received as part of an open and competitive bidding process.[206]

3. Documentation. For the decision to be adequately documented, the records of the authorized body must note:

i. the terms of the transaction and the date it was approved;
ii. the members of the authorized body who were present during the debate on the transaction or arrangement and those who voted on it;
iii. the comparability data obtained and relied upon and how the data was obtained;

202 Treas. Reg. § 53.4958-6(c)(1)(i)(A)-(C).
203 Treas. Reg. § 53.4958-6(c)(1)(ii).
204 Treas. Reg. § 53.4958-6(a)(1).
205 Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).
206 Treas. Reg. § 53.4958-6(c)(2)(i).

iv. the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction; and
v. the basis for any deviation from the range of comparable data obtained.[207]

Moreover, such records must be prepared by the next meeting of the authorized body (or within 60 days after the final action of the authorized body, if later than the next meeting) and must be reviewed and approved as reasonable, accurate and complete within a reasonable time period thereafter.[208]

[207] Treas. Reg. § 53.4958-6(c)(3)(i)(A)-(D), (ii).
[208] Treas. Reg. § 53.4958-6(c)(3)(ii).

EXPECT THE UNEXPECTED: VALUATION, PENALTY, AND LIABILITY ISSUES IN THE CONTEXT OF THE FEDERAL ESTATE TAX

by

Nikki L. Laing

I. INTRODUCTION

"Give me six hours to chop down a tree and I will spend the first four sharpening the axe."
~ Abraham Lincoln

Preparing Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, is arguably one of the most research-intensive tax returns involving a single taxpayer in existence today. The preparer is required to gather information on transactions that may encompass a person's entire lifetime. Collecting this information is complicated by the fact that the person on whom the information is being collected is deceased. The recent increases in the exemption amount has resulted in fewer estates being required to file an estate tax return. In spite of this, the relatively new portability provisions have resulted in many estates under the filing threshold choosing to file Form 706 anyway so that the decedent's unused exemption amount can be carried over to the surviving spouse.

Gathering the information required to prepare the estate tax return is a complex, tedious endeavor, and it is important to get off on the right foot in order to avoid costly consequences to the estate and its beneficiaries. This article addresses a number of actions for the preparer to set in motion (preferably as soon as the estate is opened) and pitfalls to watch out for to avoid becoming overwhelmed.

Should the taxpayer file Form 706? As a preliminary consideration, it is important to timely gather enough data so that the representative of the estate can make an educated decision about whether it will be necessary to file Form 706. Sections III.A and III.B below describe circumstances in which an estate tax return should be filed.

If it is determined that an estate tax return will be filed, gathering adequate information at an early stage is necessary to establish a basis for estimating the amount of the estate's tax liability. For the reasons discussed in Section IX.B below, it is essential for the estate representative to be able to predict with some certainty the amount of estate tax that will be due within a relatively short amount of time from the date of the decedent's death. It is even more important for a representative of an illiquid estate to have this information early on, since it may be necessary for the representative to arrange for alternate payment methods such as borrowing funds or selling estate assets.

When it comes time to file the estate tax return, it is imperative that the values reported on the return conform to the requirements of the Internal Revenue Code. This includes the values assigned to assets included in the gross estate (discussed in Section V below), as well as the value of items deducted from the gross estate (discussed in Section VI below).

As covered in Section IX below, failing to timely file the estate tax return, timely pay the estate tax, and properly report the values of the gross estate and related deductions can result in significant financial penalties. It is the practitioner's job to help the estate avoid these costly penalties. Additionally, as discussed below in Section X, failing to timely pay the estate tax can impose liability not only on the estate, but on the personal representative and beneficiaries of the estate.

With sufficient preparation, the practitioner can assist the personal representative of the estate in the preparation of an accurate, timely tax return without becoming overwhelmed by the details of this arduous task.

II. SCOPE

This article provides some general rules relating to the preparation of Form 706. However, there are a number of exceptions to these general rules that are not addressed in this article. This article does not provide a comprehensive analysis of all of the types of items reported on Form 706 and its accompanying schedules, and analysis is limited to certain issues related to the valuation of particular assets included in gross estate and certain items deducted from gross estate. While this article addresses certain penalties related to the estate tax return, there are other penalties that are not covered by this article. For purposes of this article, it is assumed that the deceased person ("decedent") was a United States citizen residing in the United States, with the same being true of the surviving spouse. It is also assumed that all property owned by the deceased person and surviving spouse is located in the United States. The scope of this article does not include the Generation Skipping Transfer tax or issues related to bankruptcy proceedings.

III. FILING REQUIREMENTS

A. Gross Estate Exceeds Filing Threshold

An estate tax return is required to be filed if the combined value of the decedent's gross estate and taxable lifetime gifts[1] made by the decedent exceeds the applicable exclusion amount.[2] The gross estate is defined as "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."[3] A common myth is that non-probate assets[4] such as life insurance are not subject to the estate tax. This is not true! The gross estate for federal estate tax purposes includes both probate and non-probate assets. The applicable exclusion amount is $5.34 million for decedents dying in 2014 and $5.43 million for decedents dying in 2015.[5] Therefore, if a person dies in 2015 with a gross estate valued at more than $5.43 million, an estate tax return must be filed. This is true even if there is no estate tax due.

B. Portability Election

Even when an estate tax return is not required to be filed because the value of the gross estate does not exceed the applicable exclusion amount, it may be desirable to file a timely Form 706 in order to elect portability of the decedent's unused exclusion amount. When a married person dies, the decedent's unused exemption ("DSUE") amount can be carried over to the surviving spouse. The surviving spouse can then apply that carried-over exemption to lifetime gifts, or it can be used by the surviving spouse's estate at death. For the DSUE amount to be carried over for the surviving spouse to use, the executor of the decedent's estate must elect portability of the DSUE amount on a timely-filed Form 706.[6] Filing Form 706 is currently the only way for the decedent's DSUE amount to be transferred to the surviving spouse, and once the election is made it is irrevocable."[7] When Form 706 is filed solely for the purpose of electing portability, the filing deadlines discussed in Section III.C below still apply. "No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return."[8] However, when Form 706 is filed solely to elect portability, special relaxed valuation rules may apply in certain circumstances, as discussed in Section V.P.1 below. In a recent letter to the IRS and the Department of the Treasury, the AICPA recommended that a surviving spouse be allowed to elect portability even if the executor of the estate declined to file Form 706, and that a "short Form 706-EZ" be made available for otherwise exempt estates to make the portability election.[9]

C. Filing Form 706

1. Due Date

Form 706 must be filed within nine months after the date of the decedent's death.[10]

[1] Post-1976 adjusted taxable gifts and the aggregate amount allowed as a specific exemption for gifts made by the decedent after September 8, 1976, but before 1977.
[2] *See* I.R.C. § 6018.
[3] I.R.C. § 2031(a). See Section V, *infra*, for more details on what is included in a decedent's gross estate.
[4] Non-probate assets are assets that are not subject to administration by the probate court.
[5] Rev. Proc. 2014-61, 2014-47 I.R.B. 860.
[6] Treas. Reg. § 20.2010-2T.
[7] I.R.C. § 2010.
[8] *Id.*
[9] *See* AICPA Letter dated March 19, 2015, http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/ aicpa_ comments_on_portability_relief_extend_request-3-19%2015.pdf.
[10] I.R.C. § 6075.

2. Automatic Six-Month Extension of Time To File

An automatic six-month extension of time to file is available for an estate which files a properly-completed Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*, within nine months from the decedent's date of death.[11]

3. Good Cause Extension of Time To File

Alternatively, the IRS may grant an extension of time to file Form 706 if the estate can show that a set of narrow circumstances exist.[12] No other extensions are allowed for filing.

4. Extension of Time To File Does Not Extend Time To Pay

The estate tax (as shown on the estate tax return) must be paid no later than nine months after the date of the decedent's death.[13] This is a firm deadline which is "determined without regard to any extension of time for filing the return."[14] "An extension of time for filing a return does not operate to extend the time for payment of the tax."[15] Therefore, even if the estate obtains an automatic six-month extension of time for filing Form 706, the estate tax must still be paid within nine months from the date of death. See Sections IV.C.2 through IV.C.4 below for options available for extending the time to pay.

D. Who Is Responsible for Filing Form 706?

If an estate tax return is required to be filed due to the size of the estate (see Section III.A, *supra*) or will be filed solely to elect portability of the decedent's unused exemption amount (see Section III.B, *supra*) the "executor" is responsible for filing Form 706 on behalf of the estate.[16] This is a nondelegable duty of the executor.[17] For purpose of filing Form 706, the term "executor" typically refers to the official court-appointed representative of the estate (i.e., the executor or administrator). However, if there is no acting executor or administrator of the estate, the term "executor" is defined in the regulations as "any person in actual or constructive possession of any property of the decedent," including "the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country."[18] "In all cases where the gross estate at the death of a citizen or resident exceeds the basic exclusion amount in effect under section 2010(c) for the calendar year which includes the date of death, the executor shall make a return with respect to the estate tax imposed by subtitle B."[19] "If the executor is unable to make a complete return as to any part of the gross estate of the decedent, he shall include in his return a description of such part and the name of every person holding a legal or beneficial interest therein. Upon notice from the Secretary such person shall in like manner make a return as to such part of the gross estate."[20] "The term 'executor' wherever it is used in this title in connection with the estate tax imposed by this chapter means the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent."[21]

[11] Treas. Reg. § 20.6081-1.

[12] *See* Treas. Reg. § 20.6081-1(c) (Upon a showing of good and sufficient cause, the IRS may grant an extension of time to file to "an estate that did not request an automatic extension of time to file Form 706 prior to the due date . . . [and the estate can show] good cause for not requesting the automatic extension"; "an estate or person that is required to file forms other than Form 706"; or "an executor who is abroad.").

[13] Treas. Reg. § 20.6151-1.

[14] *Id.*

[15] Treas. Reg. § 20.6081-1.

[16] *See* I.R.C. § 6018.

[17] *See United States v. Boyle*, 469 U.S. 241, 252 (1985).

[18] Treas. Reg. § 20.2203-1.

[19] I.R.C. § 6018(a)(1).

[20] I.R.C. § 6018(b).

[21] I.R.C. § 2203.

IV. PREPARATION FOR FILING AND PAYING

A. Gathering Information and Documents

It is important to begin preparation early in the process.[22] Even if it is anticipated that an extension request will be filed, laying the groundwork early is necessary to gather the information needed to determine whether the estate is taxable and, if so, the estimated amount of the estate's tax liability. In addition, it is important to allow plenty of time to obtain from third parties documents that must be attached to the estate tax return, such as a certified copy of the decedent's Last Will and Testament, Forms 712 for life insurance proceeds, and valuation reports from appraisers. Getting a jump on obtaining these items will make the process smoother down the road when the deadline approaches for filing Form 706.

It is often helpful to provide the executor with a questionnaire regarding assets, liabilities, and administrative expenses that tracks the schedules of Form 706. Other sources of information may include the decedent's tax return preparer, financial advisor, attorney, banker, and insurance agent. Tax assessor records should be researched to identify real and personal property of the decedent, as well as businesses in which the decedent may have had an interest. Among other documents, the preparer should review the last three income tax returns filed by the decedent. Tax returns may reveal unknown assets (evidenced by income items) and unknown liabilities (evidenced by deductions for interest and depreciation). If the executor does not have access to copies of the decedent's last three income tax returns, the executor can request copies from the IRS in the manner discussed below in Section VII.B.

B. Will Form 706 Be Required?

As covered in Section III.A, *supra*, a timely estate tax return must be filed if the combined value of the decedent's gross estate and taxable lifetime gifts exceeds the applicable exclusion amount in effect in the year of the decedent's death. The practitioner must gather sufficient information early on in the process to determine whether the value of the decedent's gross estate combined with the decedent's taxable lifetime gifts exceeds the filing threshold. A timely estate tax return will also need to be filed if the executor plans for the decedent's unused exemption amount to be carried over to the decedent's surviving spouse, as discussed above in Section III.B. If either of these circumstances exist, the practitioner must advise the executor to file Form 706 (or an extension request) by the due date.

C. Estimating the Estate Tax Liability

To estimate the amount of tax that will be due, the practitioner must gather information on assets that will be included in the gross estate, as well as expenses of the estate and other potential deductions. In addition, the practitioner must learn the value of any taxable gifts made by the decedent during the decedent's lifetime. Very simply put, the tax rate from the tax table below[23] is applied to the outcome of the following formula to arrive at the estate tax due:

[(gross estate – deductions) + taxable lifetime gifts made by the decedent] – exclusion amount.

As a basic example for discussion purposes only, suppose a person who had made no taxable gifts during his life died in 2014 with a gross estate of $5,540,000 when the exclusion amount was $5,340,000. Deductible expenses of administration totaled $40,000. The tax rate from the table below would be applied to the amount of $160,000.[24] The estate tax liability would be $42,000.[25]

[22] *See* 2 Handling Fed. Est. & Gift Taxes § 22:1 (6th ed).
[23] Taken from *Instructions for Form 706 (Rev. August 2014)*, page 5.
[24] [($5,540,000 gross estate - $40,000 deductions) + $0 gifts] - $5,340,000 exclusion = $160,000.
[25] $38,800 + [($160,000 - $150,000) x 32%)] = $42,000.

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A
0	10,000	0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	- - - -	345,800	40%

1. Determining Amount To Submit with Extension Request

If an extension of time to file is made, the representative of the estate must include a check or money order for the estimated amount of estate tax along with Form 4768. Obviously, the preparation of Form 706 is required to calculate the estate's tax liability. However, the extension request is being made presumably because the preparation of Form 706 will not be complete by its due date. Because of this paradox, estimating the amount of estate tax can present a challenge for the representative of the estate. There are a number of considerations when submitting a check or money order for the amount of the estimated estate tax with Form 4768.

a. Remitting Too Much vs. Too Little

If the executor remits too great an amount with Form 4768, the estate could run the risk of illiquidity for payment of other obligations and loss of opportunity of return on invested cash. However, the risks associated with overpayment must be carefully weighed against the risk of significant penalties and interest if the amount remitted with Form 4768 ends up being less than the amount of tax ultimately due. In addition to the risks of illiquidity and loss of investment returns, an executor of an estate consisting of mostly noncash assets may need to sell assets to raise the funds to submit with Form 4768. The forced sale of assets in order to make the nine-month deadline may result in the assets being sold at a sacrifice. Again, the executor must evaluate the risks and benefits involved in selling assets at sacrifice prices versus penalties and interest that may be assessed by the IRS for failure to submit adequate funds for payment of the estate tax with Form 4768.

b. Payment vs. Deposit

Generally, a remittance that accompanies an extension request is treated as a payment by the IRS. In some situations, it is beneficial for a remittance submitted with an extension request to be treated as a deposit rather than a payment.[26] A discussion of the pros and cons of having a remittance treated by the IRS as a payment or deposit falls outside the scope of this article.[27] To have the funds that are sent with

[26] I.R.C. § 6603 allows a taxpayer to make a cash deposit to suspend interest on potential underpayments. Until it is applied by the IRS to an assessed tax liability, a *deposit* is not subject to the time limitations applicable to refund claims for *payment* of tax.

[27] Recent cases involving this issue include *Syring v. United States*, No. 12-CV-232-WMC, 2013 WL 4197143 (W.D. Wis. Aug. 15, 2013) (where estate's remittance submitted with extension request exceeded the estate's ultimate tax liability by more than $140,000, estate was barred from refund claim under I.R.C. § 6651(a) and (b)(2)(A) because remittance was a "partial tax payment" and not a "deposit") and *Winford v. United States*, 587 F.

the estate’s extension request treated as a deposit under § 6603 rather than a payment, the executor should carefully follow the instructions given in Revenue Procedure 2005-18.[28]

2. Request for Extension of Time To Pay

For an estate that is unable to utilize the methods listed below in Section VIII to pay the estate ta by the nine-month deadline, the executor may attempt to obtain an extension of time to pay. While there is very little leniency for failing to file the Form 706 by its due date, there are more options available for extending the time to pay the tax.

3. Reasonable Cause or Undue Hardship

An extension of time to pay any part of the tax shown on the estate tax return may be granted “for a reasonable period of time, not to exceed 12 months,” if the executor can establish “that such request is based upon reasonable cause.”[29] Some examples of “reasonable cause” include the following:

> (1). An estate includes sufficient liquid assets to pay the estate tax when otherwise due. The liquid assets, however, are located in several jurisdictions and are not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence. . . . (2). An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate. . . . (3). An estate includes a claim to substantial assets which cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due. . . . . (4). An estate does not have sufficient funds (without borrowing at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash.[30]

Alternatively, an extension of time to pay any part of the tax shown on the estate tax return may be granted “for a period or periods not to exceed one year for any one period and for all periods not to exceed 10 years” when the executor can show that payment on the due date would “impose undue hardship upon the estate.”[31] “Undue hardship” means “more than an inconvenience to the estate.”[32] An extension request based on undue hardship “will not be granted upon a general statement of hardship or merely upon a showing of reasonable cause.”[33] The following are examples which illustrate cases where an extension of time will be granted based on “undue hardship”:

> (1). A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of section 6166(a) (relating to an extension where

App'x 207 (5th Cir. 2014) (remittance was a “payment” and thus the refund was barred by the applicable statute of limitations).

[28] *See* Rev. Proc. 2005-18, 2005-1 C.B. 798.

[29] Treas. Reg. § 20.6161-1(a)(1).

[30] *Id.*

[31] Treas. Reg. § 20.6161-1(a)(2)(i).

[32] Treas. Reg. § 20.6161-1(a)(2)(ii).

[33] *Id.*

> the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax. . . . (2). The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due.[34]

Notwithstanding the examples above, the Treasury regulations provide that "a sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate."[35]

a. Relationship Between § 6161 Extension and § 6651 Excuse for Late Payment

The elements required to qualify for an extension of time to pay under § 6161 are interrelated with the elements required to be excused for late payment under § 6651, discussed in Section IX.C.2, *infra*. Generally, if one does not qualify for a § 6161 extension, one will not qualify for relief under § 6651. *Estate of Hartsell v. C.I.R.* provides some excellent examples of what not to do when trying to obtain an extension of time to pay under the "undue hardship" prong of § 6161.[36] In *Estate of Hartsell*, the estate consisted mostly of nonliquid assets. The IRS granted the executor's first two § 6161 requests for extension of time to pay, but denied the third request. After the third extension request was denied, the estate tax remained unpaid and the case ended up in Tax Court. Because the estate in *Hartsell* contained few liquid assets from which to pay its estate tax liability, the executor had to look to a variety of other methods to raise the funds to pay the tax. Two options available to the executor included selling real property belonging to the estate and borrowing funds against estate assets. The court pointed to a number of reasons why the executor failed to qualify for the § 6161 extension. Rather than placing all of the real property for sale, the executor "chose to sell a mere five properties from an estate composed of more than 60 properties."[37] The executor did not hire a real estate professional to help him sell the properties. Instead of marketing the real estate in a commercially reasonable manner, the executor simply "advertised the properties by placing a single 'for sale' sign on each with a phone number."[38] In addition, the executor did not market the properties at a reasonable price, but set the price well above market value. Not surprisingly, the property did not sell and the estate tax remained unpaid. The court attributed this to "the lack of interest in the estate's properties [because of] its arbitrary prices, negligible marketing efforts, too few properties advertised, a desire to save paying third parties other than [the executor] and his sons, and, overall, a desire to sell at a profit rather than at current market prices."[39] When the executor used the failure of the properties to sell as the basis for his "undue hardship" claim under § 6161, the court noted that the executor's disingenuous efforts did not "constitute the serious effort required to pay the Federal estate tax timely."[40] Citing the Treasury regulations, the court explained that "if a market exists, the sale of property at the current market price is not ordinarily considered an undue hardship."[41] The court further pointed out that the executor did not make sufficient efforts to obtain a loan, noting that there was "no evidence in the record that [the executor] ever submitted a formal loan application" and "no effort [was made] to sell or borrow against the estate's mineral interests or its portfolio of stocks and

[34] *Id.*
[35] *Id.*
[36] *See generally Estate of Hartsell v. C.I.R.*, T.C. Memo. 2004-211.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*

bonds."[42] *Estate of Hartsell* demonstrates how insincere attempts at raising funds are not sufficient to obtain an extension for time to pay the estate tax under § 6161.

b. Application for Extension

An application for an extension of time for paying the tax shown on the return must be made on or before the nine-month filing deadline, and it must include a declaration that it is made under penalties of perjury.[43] The application must state whether the request for extension is based upon reasonable cause or undue hardship (or based upon undue hardship with an alternative request for reasonable cause). The application must explain in detail why reasonable cause exists or the undue hardship that would result if the request for extension were denied. The request for extension of time to pay should be made on a timely-filed Form 4768. One case in particular serves as a warning to fill out Form 4768 properly. In *Baccei v. United States*, the executor hired a certified public accountant to prepare and file the federal estate tax return on behalf of the estate.[44] Because of some issues with the bank that was holding the estate funds, the executor was unable to submit an estimated tax payment to the IRS by the nine-month due date.[45] The CPA timely filed Form 4768 in attempt to request an extension of time to file and time to pay. However, the CPA left several fields of Form 4768 blank, including Part III, "Extension of Time to Pay."[46] The CPA included a letter with Form 4768 explaining the issues that the executor was having with the bank and stating that "[w]e seek this extension of time to pay as well as asking that no penalty be asserted."[47] The IRS took the position that the executor failed to request an extension of time to pay because Form 4768 was incomplete, and consequently assessed a substantial failure-to-pay penalty against the estate. The executor argued in district court that he had made "a valid late payment request."[48] The district court granted summary judgment in favor of the IRS on grounds that the executor had not strictly complied with requirements set forth in the regulations governing requests for payment extensions. On appeal, the Ninth Circuit affirmed, holding that "the substantial compliance doctrine [did] not excuse [the executor's] failure to strictly comply with the regulations governing requests for extension of time to pay estate taxes."[49]

4. Election To Defer Taxes on Closely Held Business

a. § 6166 Election

When more that 35 percent of the value of the adjusted gross estate is attributable to a closely held business, the estate taxes applicable to the closely held business may be deferred for up to 15 years under § 6166. The term "interest in a closely held business" means: "an interest as a proprietor in a trade or business carried on as a proprietorship; an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent or such partnership had 45 or fewer partners; or stock in a corporation carrying on a trade or business if 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent or such corporation had 45 or fewer shareholders."[50] Special rules apply for aggregating two or more businesses and ownership attribution. The § 6166 election must be made by the due date of the estate tax return, including any extensions. The election can be made on Form 4768 or Form 706. For guidance on whether real property interests

[42] *Id.*
[43] Treas. Reg.§ 20.6161-1(b).
[44] 632 F.3d 1140, 1143 (9th Cir. 2011).
[45] *Id.* at 1143.
[46] *Id.*
[47] *Id.*
[48] *Id.* at 1144.
[49] *Id.* at 1149.
[50] I.R.C. § 6166.

constitute interests in a closely held business for purposes of the § 6166 deferment, see Revenue Ruling 2006-34.[51]

b. Life Vest: Protective Election

If the executor is uncertain whether the § 6166 election should be made, a protective election may be filed by including a notice with a timely-filed Form 706.[52] The notice should state that the election is being made, contingent upon final values meeting the requirements of § 6166. Once values are finally determined, a final notice of election must be made within 60 days.[53]

V. GROSS ESTATE

The "gross estate" includes everything owned by the decedent at death. For example, it includes all of the decedent's interest in real estate, stocks, bonds, cash, bank accounts, and personal property. It also includes claims that the decedent had against third parties, such as loans owed to the decedent and legal claims that the decedent had against others.

The gross estate also includes the value of some assets that were not owned by the decedent at death. For example, it includes property owned by the decedent's revocable trust, proceeds of a life insurance policy on the decedent's life which was transferred by the decedent within three years of death, and property given away by the decedent if the decedent retained certain interests in the property.[54] While this article includes some basic examples of the type of items that are included in the gross estate, a comprehensive discussion of all of the items that must be included in the gross estate is outside the scope of this article.

A. Fair Market Value

Generally, every item included in the gross estate is reported at its "fair market value."[55] Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[56] It is based on the "highest and best use" of the property and not on how the property is actually being used at the time of death.[57] "The willing buyer and seller are hypothetical, and valuation does not take into account the personal characteristics of the actual buyer or the actual seller. . . . The hypothetical

[51] Rev. Rul. 2006-34, 2006-1 C.B. 1171.

[52] Treas. Reg. § 20.6166-1(d).

[53] *Id.*

[54] *See, e.g.*, I.R.C. §§ 2034-45.

[55] Treas. Reg. § 20.2031-1(b).

[56] *Id.*; Rev. Proc. 79-24, 1979-1 C.B. 565. For an interesting case addressing the "reasonable knowledge of relevant facts" element, see *Estate of Kessel v. C.I.R.*, T.C. Memo. 2014-97. In *Kessel*, the executrix paid estate tax on a Madoff account that later turned out to be worthless. When the executrix requested a refund for the estate tax paid on the worthless account, the IRS refused on grounds that "a hypothetical willing buyer and willing seller of the Madoff account would not reasonably know or foresee that Mr. Madoff was operating a Ponzi scheme at the time Decedent died." *Id.* at *1. The IRS reasoned that, because the hypothetical buyer would not be privy to this information at the time of the decedent's death, the hypothetical buyer would set a purchase price based on the amount reflected on the false account statements supplied by the Madoff investment company. Therefore, the IRS asserted, the proper value to include in the decedent's gross estate was the value reflected on the falsified account statements. The Tax Court noted that "the value of the property to be taxed must be determined as of the time the property is transferred. . . . Value in this context is defined as fair market value—what a willing buyer would pay to a willing seller, both having reasonable knowledge of the relevant facts. . . . Accordingly, later occurring events affecting the value of the property transferred are relevant to the determination of fair market value only if they were reasonably foreseeable at the time of transfer." *Id.* at *4 (internal citations omitted). In denying the IRS's motion for summary judgment, the court pointed out that, because some people had begun to suspect Mr. Madoff of fraud years prior to the decedent's death, a hypothetical buyer would perhaps have reason to suspect that the value of the decedent's account was not what it appeared to be.

[57] *See* 2 Tax Planning Real Estate Trans. § 28:12.

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willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage, namely the maximum profit from the hypothetical sale."[58] Fair market value is based on the market in which the asset in question in typically sold, and it should not be determined by a forced sale price.[59] The actual sale price of property sold in an arms'-length transaction to an unrelated party can generally be considered as the fair market value of the property.[60] Local tax assessor values can be used only if the value is indicative of the fair market value as of the valuation date.[61] "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case."[62]

B. Date of Death Values or Alternate Valuation Date

The assets included in a decedent's gross estate are generally valued as of the date of the decedent's death.[63] However, the executor may elect an alternate valuation date for all assets in the gross estate.[64] The alternate valuation date is six months after death, or the date of disposition for assets that were distributed, sold, exchanged, or otherwise disposed of earlier than six months from the date of decedent's death.[65] The alternate valuation election may be made only if it decreases both the value of the gross estate and the amount of federal estate tax and generation-skipping transfer tax.[66]

C. Penalties for Undervaluation

Valuation obviously plays an important role in calculating the estate tax. Valuation is also important in the context of potential accuracy-related penalties. The Code provides for a penalty of 20 percent of any portion of an underpayment of estate tax that is attributable to a "substantial estate or gift tax valuation understatement."[67] A substantial understatement exists when the value reported on Form 706 is 65 percent or less of the amount determined to be the correct value. The penalty is increased to 40 percent for "gross valuation misstatements," which exist when the value reported on Form 706 is 40 percent or less of the correct value. These penalties apply only if the underpayment attributable to the understated value exceeds $5,000.[68]

D. Proper Construction of Legal Instruments and Laws

Estate planning documents and state and federal laws determine the assets that are included in a decedent's gross estate. Sometimes determining which assets are included in the gross estate is straightforward. However, the majority of the time it requires interpretation of legal instruments and laws. For example, Wills, trusts, deeds, and marital agreements require legal interpretation, as do laws relating to testamentary transfers and intestate succession. It is important for legal instruments pertaining to the gross estate and relevant laws to be construed by competent legal counsel.

Of particular importance to Texas practitioners are laws pertaining to community property, discussed further in Section V.H, *infra*. In Texas, property possessed by either spouse during marriage is presumed to be community property, meaning that each spouse owns an undivided one-half interest in the property.[69] As an example, suppose Husband owns an insurance policy on the life of Wife. Assuming the policy is community property, both Husband and Wife each have an undivided one-half ownership interest in the policy. At Husband's death, Wife retains her one-half ownership interest in the policy. So,

[58] *Estate of Adell v. C.I.R.*, T.C. Memo. 2014-155 at *12.
[59] Treas. Reg. § 20.2031-1(b). *See* Treas. Reg. §§ 20.2031-6 and 20.2031-8 for property typically sold at retail.
[60] *See* 2 Tax Planning Real Estate Trans. § 28:12.
[61] Treas. Reg. § 20.2031-1(b).
[62] *Id.*
[63] I.R.C. § 2031(a).
[64] *See* I.R.C. § 2032.
[65] *See* I.R.C. § 2032(a).
[66] I.R.C. § 2032(c).
[67] I.R.C. § 6662.
[68] *Id.*
[69] *See* Tex. Family Code § 3.003.

only one-half of the value of the policy is included in Husband's gross estate. As another example, imagine Wife owns a tract of land that is community property. Husband and Wife each own a one-half undivided interest in the land—even if the land is titled solely in Wife's name. At Husband's death, one-half of the value of the land is included in Husband's gross estate, even though the land was not titled in Husband's name. While it is always important to obtain proper construction of legal instruments and relevant laws, it is especially important when dealing with community property issues.

E. Qualified Appraiser/Appraisal

The value of certain assets included in the gross estate (such as real property and closely-held businesses), as well as the value of certain claims against the estate (such as contract or tort liabilities) should generally be supported by a qualified appraisal prepared by a qualified appraiser. The appraiser should, at a minimum, meet the following description:[70]

- independent (i.e., unrelated to the decedent and beneficiaries)
- holds himself out to the public as an appraiser
- regularly performs appraisals for which he receives compensation
- has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in the Treasury Regulations
- demonstrates verifiable education and experience in valuing the type of property subject to the appraisal
- has not been prohibited from practicing before the Internal Revenue Service within three years prior to the appraisal date
- has not previously been disqualified to testify as an expert in court

In addition to the appraiser's qualifications, courts will consider the appraiser's familiarity with the market and the methods used by the appraiser.[71] If the IRS disputes the value of an asset reported on Form 706, courts will generally decide the issue based on "which appraiser presents the most credible analysis."[72] The appraiser's report should contain the following information:[73]

- a statement establishing that the appraisal was prepared by a qualified appraiser, along with a detailed description of the appraiser's qualifications
- a statement establishing that, due to the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, he is qualified to make appraisals of the type of property being valued
- the effective date of the valuation (i.e., date of death or alternate valuation date)
- the date on which the asset was appraised
- purpose of the appraisal
- a description of the asset
- a description of the appraisal process employed
- a description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the asset that affect the appraiser's analyses, opinions, and conclusions
- the information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining

[70] *See* I.R.C. § 170(f)(11)(E); Treas. Reg. § 301.6501(c)-1(f)(3).
[71] *See* 2 Tax Planning Real Estate Trans. § 28:12.
[72] *Id.*
[73] *See* I.R.C. § 170(f)(11)(E); Treas. Reg.§ 301.6501(c)-1(f)(3).

the value of the interest, that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value

- the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions
- the valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset
- the specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, etc.

F. Discounts

A number of discounts may be applicable to the assets that are included in the gross estate. Discounts pertaining to real and personal property owned as tenants in common are discussed in Section V.I.2, *infra*. Ownership interests in closely held entities may be subject to certain discounts covered in Section V.M, *infra*. The proper amount of a discount involves a fact and circumstances test, the discount should be "supported by a valuation performed by a qualified valuation expert."[74]

G. Form of Ownership

While the general rules discussed previously in Sections V.A to V.F apply to all assets included in the gross estate for purposes of an asset's reported value, the portion of an asset that should be included in the gross estate is determined by how the decedent owned the property, as discussed below.

H. Marital Property

In Texas, property owned by either spouse during a marriage is classified as either "separate" or "community" property. Property acquired by a spouse prior to marriage or acquired by gift or inheritance during marriage (including traceable mutations of such property) is that spouse's "separate" property.[75] Everything else owned by either spouse is "community" property owned equally by the spouses (regardless of title).[76]

All assets owned by either spouse during a marriage are presumed to be community property.[77] This presumption can be overcome only by clear and convincing evidence establishing that an asset was owned by a spouse before the marriage, acquired during the marriage by gift or inheritance, or a traceable mutation of either.

If a Texas decedent is married at the time of death, community property law is an important consideration. The decedent's gross estate will include (i) all of the decedent's separate property, (ii) one-half of the decedent's community property,[78] and (iii) none of the surviving spouse's separate property.

I. Assets Owned with Others

1. Joint Interests

The term "joint interests" refers to real or personal property held jointly by the decedent and any other person(s) with right of survivorship, meaning that upon the death of one joint tenant, the property passes to the other joint tenant(s) automatically under operation of law.[79] Property held in this manner is commonly called "joint tenancy with right of survivorship." Joint interests are not entitled to valuation discounts.

[74] 2 Handling Fed. Est. & Gift Taxes § 22:1 (6th ed).
[75] Tex. Family Code § 3.001.
[76] Tex. Family Code § 3.002.
[77] Tex. Family Code § 3.003.
[78] There is no family attribution with respect to the surviving spouse's one-half interest in the property. *See generally Bright's Estate v. United States*, 658 F.2d 999 (5th Cir. 1981).
[79] Treas. Reg. § 20.2040-1.

When a decedent owned property as a joint tenant with rights of survivorship, the portion of that property included in the decedent's gross estate is based on the amount of consideration furnished by the decedent relative to the consideration furnished by the other joint tenant(s), unless the property was a gift to all of the joint tenants.[80] For example, if the decedent paid the entire purchase price of the property, the entire value of the property is included in the gross estate.[81] If the decedent paid only some of the purchase price, the corresponding fraction of the value of the property is included in the gross estate.[82] If the decedent did not pay any of the purchase price, then no part of the property is included in the gross estate.[83]

If the property was acquired by gift or inheritance by the decedent and all other joint tenants, then the decedent's fractional share of the property is included in the gross estate.[84]

It is important to note that, although the portion of the value of jointly-held property included in the gross estate is based on either the consideration-furnished test or the fractional-share test (if the property was acquired entirely by gift or inheritance), it is presumed that the decedent furnished all of the consideration for the property.[85] Therefore, unless this presumption is overcome by showing either that the property was not acquired entirely with consideration furnished by the decedent or that it was acquired entirely by gift or inheritance, the full value of jointly held property will be included in the gross estate.[86]

These rules do not apply to Qualified Joint Interests owned by spouses. A Qualified Joint Interest is property held by the decedent and the decedent's spouse as tenants by the entirety (not applicable in Texas) or as joint tenants with right of survivorship (if the decedent and spouse are the only joint tenants).[87] Irrespective of how the property was acquired, one-half of the value of Qualified Joint Interest property is included in the gross estate.

2. Tenancy in Common

When property is held as a tenancy in common, it is owned by two or more persons (cotenants) in equal or unequal undivided shares, with each cotenant having the right of possession of the entire property.[88] In contrast to joint tenants, tenants in common do not have the right of survivorship.

a. Discount for Restrictive Covenants

Sometimes co-owners of property held as tenancy in common will enter into an agreement which limits the co-owners' ability to sell or transfer their interests in the property. Does the existence of such an agreement make the value of a decedent's interest eligible for a discount because of the restriction on the disposition of the property? Under the general rule, the answer is "no." Value is generally determined "without regard to . . . any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or [] any restriction on the right to sell or use such property."[89] However, an exception to the general rule provides that an option, agreement, right, or restriction will not be disregarded for valuation purposes if it meets each of the following requirements: "(1) It is a bona fide business arrangement. (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate

[80] Treas. Reg. § 20.2040-1(a)(2).
[81] Treas. Reg. § 20.2040-1(c).
[82] *Id.*
[83] *Id.*
[84] Treas. Reg. § 20.2040-1(a)(1).
[85] Treas. Reg. § 20.2040-1(a)(2).
[86] *Id.*
[87] I.R.C. § 2040(b)(2).
[88] *See* BLACK'S LAW DICTIONARY (10th ed. 2014).
[89] I.R.C. § 2703(a).

consideration in money or money's worth. (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction."[90]

b. Discount for Fractional Ownership

Real or personal property owned as tenants in common may be subject to a discount for fractional ownership.[91] A discount for a fractional interest in property may be appropriate because owners of such interests are usually limited in how they can use the property, and they are burdened with the hassle of dealing with the other owners. In addition, when the owner seeks to dispose of the property, he may face impediments such as "possible delays and costs involved in severance proceedings."[92] An owner may also face "costs and fees associated with partition or other legal controversies among owners, along with a limited market for fractional interests and lack of control."[93] For these and other reasons, a prospective purchaser would likely refuse to the pay the full pro-rata portion of the entire value of the property for an undivided fractional interest in the property.

"Courts have consistently recognized that the sum of all fractional interests in a property is less than the whole and have upheld the use of fractional interest discounts in valuing undivided interests."[94] Fractional ownership discounts have been applied to real property,[95] timber land,[96] mineral interests,[97] and personal property such as works of art[98] and boats.[99]

J. Life Estate / Remainder Interests

Simply put, a life estate is an interest in property whereby the life tenant is granted the right to use, possess, or enjoy the property during his or her life. At the death of the life tenant, full ownership of the property generally passes to the holder(s) of the remainder interest.

While life estates are not a common method of transferring real property these days, they are still encountered in the context of intestacy laws. For example, when a Texas resident dies without a valid Will, there are situations where the surviving spouse will inherit a life estate in one-third of the decedent's real property, with the remainder interest passing to the decedent's children.[100] If this scenario applies to a decedent's estate for whom an estate tax return is being prepare, both the life estate and remainder interest must be valued. In addition, the value of the life estate is relevant to the calculation of the marital deduction, discussed below in Section VI.A.

Generally, the value of the life estate is based on the present value of the property (using a given discount factor) and the life expectancy of the life tenant. See Treas. Reg. § 20.2031-7(d)(2)(iii) for instructions on computing the value of life estate and remainder interests.

K. Real Estate

Generally, real estate is valued using three methods.[101] The comparable sales approach, or market approach, bases the valuation on recent sales of similar property. The income approach values the financial benefits (e.g., future rental income) to be derived from the property. If neither of these methods

[90] I.R.C. § 2703(b).
[91] *See* 2 Handling Fed. Est. & Gift Taxes § 22:1 (6th ed).
[92] *Knapp v. C.I.R.*, T.C. Memo. 1977-389.
[93] *Estate of Bonner v. United States*, 84 F.3d 196, 197-98 (5th Cir. 1996).
[94] *Id.* at 197.
[95] *See generally id.*
[96] *See generally Baird. v. C.I.R.*, T.C. Memo. 2001-258.
[97] *See generally Estate of Smith v. C.I.R.*, T.C. Memo. 1993-236.
[98] *See generally Estate of Elkins v. C.I.R.*, 767 F.3d 443 (5th Cir. 2014).
[99] *See generally Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996).
[100] *See* Tex. Estates Code § 201.002.
[101] *See generally Estate of Berg v. C. I. R.*, T.C. Memo. 1991-279 *aff'd in part, rev'd in part*, 976 F.2d 1163 (8th Cir. 1992).

are suitable for valuing the real property in question, the property may be valued using the cost of replacement approach.

As mentioned previously, fair market value typically is based on an asset's "highest and best use." This principle is particularly applicable to real estate for which a variety of uses may exist, each having a different return potential. For example, the decedent may have owned interstate frontage property which was being used to graze cattle. The value of the property under the decedent's use may differ significantly from the value of the property if it were used for commercial purposes (i.e., its "highest and best use"). See Section V.P.2 below for an exception to the "highest and best use" valuation requirement that may be available for certain estates.

L. Securities

1. Publicly-traded Stocks and Bonds

Stocks and bonds traded in the markets are valued using the following formula: "the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond. If there were no sales on the valuation date but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the valuation date. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date."[102] Simple, right? Rather than hunting down the data required and then performing the complex calculations involved in the formula, this practitioner relies on the "EstateVal" service provided by Estate Valuations & Pricing Systems, Inc. to value publicly-traded stocks and bonds owned by the decedent.[103] According to the company's website, "The IRS uses EstateVal to verify all pricing on Form 706."

2. Nonpublicly-traded Stocks and Bonds

As with real estate, there are three main approaches to valuing nonpublicly-traded stock.[104] The market approach compares the stock owned by the decedent to the same or comparable stock that was sold in arms'-length transactions close to the valuation date. The income approach uses the present value of the anticipated economic benefits of owning the stock. The cost approach, or asset-based approach uses the value of the company's assets net of its liabilities.

A number of factors are considered when valuing privately-traded securities. In the case of corporate bonds, the soundness of the security, the interest yield, and the date of maturity must be considered, among other factors.[105] With stock, the factors to consider include the company's net worth, prospective earning power and dividend-paying capacity, the goodwill of the business, and the industry's economic outlook.

M. Closely Held Business

The decedent's gross estate may include ownership in a business structured as a sole proprietorship, partnership, limited liability company, or corporation. The regulations provide that the "fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[106] The value is based on "all relevant factors," including an appraisal of all tangible and

[102] Treas. Reg. § 20.2031-2(b).
[103] Information on the EstateVal service is available at http://www.evpsys.com/.
[104] *See Estate of Noble v. C.I.R.*, T.C. Memo. 2005-2.
[105] Treas. Reg. § 20.2031-2(f)(1).
[106] Treas. Reg. § 20.2031-3.

intangible assets of the business (including goodwill),[107] earning capacity, economic outlook in the industry, and the company's position in the industry.[108] If the business is structured as a corporation, the company's net worth, prospective earning power and dividend-paying capacity must be considered.[109] Other factors relevant to valuation of a corporation are the corporation's position in its industry, the industry's economic outlook, and the degree of control represented by the block of stock to be valued. "Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as of or near the applicable valuation date."[110]

To prepare a valuation report, the business valuation expert will need to be provided with information such as the entity's balance sheet, copies of the entity's income tax returns for the prior three to five years, and a description of the other owners and the company's management structure. The valuation expert will likely require recent appraisals showing the fair market value of all real property owned by the entity.[111]

1. Discount for Lack of Control (Minority Interest)

When the decedent owned a minority block of stock in a corporation, a minority membership interest in a limited liability company, or a limited partnership interest in a limited partnership, a discount for lack of control may be applied to the value of the decedent's interest.[112] This minority interest discount accounts for the owner's inability to influence the entity's management decisions, such as payment of dividends or distributions and liquidation and merger activities.[113] In contrast to the minority interest discount, it is possible for a control premium to be imposed on the value of a majority shareholder's stock or general partnership interest.

2. Discount for Lack of Marketability

A discount for lack of marketability is often applied to ownership interests in closely held entities because of the general lack of demand for such interests.[114] Often, such interests are not attractive to company "outsiders." The lack of demand for such an interest can result in a lengthy period on the market and a below-market sale price. The discount for lack of marketability reflects the obstacles that an owner of an interest in a closely held company may face in the efforts to liquidate the interest.[115]

In addition to the interest being generally unattractive to outsiders, there may be limitations on the owner's ability to dispose of the interest. This may be the result of agreements that exist between partners, members, or shareholders. The discount for lack of marketability is sometimes attributable to the existence of restrictive covenants, discussed in Section V.I.2.a, *supra*.[116]

[107] Regarding an economic charge for personal goodwill, see *Estate of Adell v. C.I.R.*, T.C. Memo. 2014-155 at *16 ("The corporation may benefit from using the personally developed goodwill while the key employee works for the entity, but the corporation does not own the goodwill and therefore it is not considered a corporate asset. . . . The employee may, however, transfer any personal goodwill to the employer through a covenant not to compete or other agreement that transfers the relationships to the employer. . . . Absent such an agreement, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation." (internal citations omitted)).

[108] Treas. Reg. § 20.2031-3; Treas. Reg. § 20.2031-2(f).

[109] Treas. Reg. § 20.2031-2(f)(2).

[110] Treas. Reg. § 20.2031-3(c).

[111] 2 Handling Fed. Est. & Gift Taxes § 22:1 (6th ed).

[112] *See Estate of Tanenblatt v. C.I.R.*, T.C. Memo. 2013-263 at *11 (recognizing lack of control discount applicable to stock of closely held corporation and membership interest in limited liability company).

[113] *See* 2 Tax Planning Real Estate Trans. § 28:13.

[114] *See Estate of Tanenblatt v. C.I.R.*, T.C. Memo. 2013-263 at *11 (recognizing lack of marketability discount applicable to stock of closely held corporation and membership interest in limited liability company).

[115] *See id.*

[116] Caveat: see I.R.C. § 2704 for limits on discounts available to certain entities owned by family members.

N. Life Insurance

The executor will need to obtain a Form 712 for each life insurance policy that is included in the gross estate, whether the insured is the decedent or another person. Depending on the executor's knowledge of the decedent's affairs, it may be advisable for the executor to submit a request to the Texas Department of Insurance Life Policy Locator Service to obtain information on life insurance policies or annuity contracts in the name of the decedent.[117]

1. Life Insurance on Decedent's Life

Life insurance proceeds are included in the gross estate under three scenarios. First, the proceeds of insurance on the decedent's life are included in the gross estate if the proceeds are received by the decedent's estate, regardless of who owned the policy on the date of death.[118] Second, if the decedent possessed "incidents of ownership" in the policy at the time of death, the proceeds are included in the gross estate regardless of who is the beneficiary of the policy.[119] Third, even if the decedent did not possess "incidents of ownership" in the policy on the date of death, the proceeds are included in the gross estate if the decedent formerly possessed "incidents of ownership" and transferred such interests to a third party within three years from the date of death.[120]

2. Life Insurance Owned by Decedent on the Life of Another

The value of a life insurance policy owned by the decedent on the life of someone else, such as the decedent's spouse, is provided by the insurance company, generally at the interpolated terminal reserve value. If the policy is held as community property, then only the value of the decedent's one-half interest is included in the gross estate.

O. Claims Against Others

Claims that the decedent held against others, such as debts due to the decedent and judgments awarded to the decedent, are included in the gross estate. Because "the decedent's gross estate includes all of the decedent's property at the time of death, including assets of uncertain value," pending claims that the decedent had against others are included in the gross estate, as well as claims that have been reduced to judgment or otherwise finalized as of the decedent's death.[121] In contrast to claims *against the estate*, which generally must be "ascertainable with reasonable certainty" in order to be deducted from the gross estate (see Section VI.E, *infra*), pending claims *held by the estate* are included in the gross estate even if they are not "ascertainable with reasonable certainty."[122]

P. Special Valuation Rules

1. Relaxed Valuation Rules for Portability

A particularly interesting rule concerning the portability election provides that an estate with a value (when combined with taxable lifetime gifts) that is less than the basic exclusion amount and that is not otherwise required to file an estate tax return does not have to report the value of certain property that qualifies for the marital or charitable deduction. However, the executor must identify such property on the return, as well as attach documentation verifying that title to such property passed to the surviving spouse or charity in a qualifying manner. If an executor chooses to make use of this special rule in filing an estate tax return, the Instructions for Form 706 provide ranges of dollar values, and the executor must identify on the estate tax return the particular range within which falls the executor's best estimate of the

[117] Information about the Life Insurance Policy and Annuity Locator provided by the Texas Department of Insurance is available at: http://www.tdi.texas.gov/life/life.html.

[118] *See* Treas. Reg. § 20.2042-1(b).

[119] Treas. Reg. § 20.2042-1(c).

[120] *See* I.R.C. § 2035.

[121] *Estate of Saunders v. C.I.R.*, 745 F.3d 953, 962 (9th Cir. 2014).

[122] *See id.*

total gross estate. In doing so, the executor must estimate the total value of the gross estate (including the values of the marital- and charitable-deduction property that does not have to be reported on the estate tax return) based on a determination made in good faith and with due diligence regarding the value of all of the assets includible in the gross estate.[123]

2. Special Valuation for Real Property – Farm or Closely Held Business

a. Section 2032A Election

An executor may elect to value certain qualifying real property at its value as a farm or closely held business rather than at the value it would have at its highest and best use.[124] There is a complex set of factors that must be met in order for real property to qualify for the special use valuation. For example, certain percentage tests must be met relating to the adjusted value of the gross estate, the property must be passed from the decedent to a qualified heir of the decedent, and the property must have been in qualified use (i.e., farming or trade or business) by the decedent or a member of the decedent's family on the date of death.[125] The Code provides the formula for valuing such property, which typically involves capitalizing the average annual cash or crop rental for comparable property for the prior five years at the average interest rate for Farm Credit Bank Loans.[126] There is a limit on the amount that the gross estate can be reduced by electing special use valuation.[127] For decedents dying in 2014, the gross estate cannot be decreased by more than $1,090,000.[128] The limit is $1,100,000 for decedents dying in 2015.[129] To make the election, the executor must attached a notice of election to a timely-filed estate tax return, along with an agreement with the Service executed by all parties who have any interest in the property that is being specially valued.[130] The Service has provided a sample agreement for this purpose.[131] There are a number of significant, long-term conditions not covered in this article that apply to property for which the § 2032A election is made, and the executor and all recipients of the property must be fully informed of the conditions and their consequences before the election is made.[132]

b. Protective Election

A protective election may be made to specially value qualified real property by including a notice with the timely-filed estate tax return stating that a protective election under § 2032A is being made pending final determination of values.[133] If the estate ultimately qualifies for special use valuation, an additional notice of election must be filed within 60 days after the date that such qualification is determined.[134] Along with the notice of election, the executor must file an amended estate tax return reflecting the final values of the § 2032A property and the agreement referenced in Section V.P.2.a above executed by all parties who have any interest in the property.[135]

[123] *See* Temp. Treas. Reg. § 20.2010-2T(a)(7)(ii).

[124] *See* I.R.C. § 2032A.

[125] *See* I.R.C. § 2032A and related Treasury regulations for the complete set of factors that must be met for property to qualify for the special valuation.

[126] *See* I.R.C. § 2032A(e)(7)-(8).

[127] *See* I.R.C. § 2032A(a)(2).

[128] Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[129] Rev. Proc. 2014-61, 2014-47 I.R.B. 860.

[130] *See* I.R.C. § 2032A(d)(2).

[131] *See* Rev. Proc. 81-14, 1983-1 C.B. 669.

[132] *See* I.R.C. § 2032A and related Treasury regulations for conditions related to premature disposition of the property or cessation of qualified use.

[133] *See* Treas. Reg. § 20.2032A-8(b).

[134] *See id.*

[135] *See id.*

VI. DEDUCTIONS FROM GROSS ESTATE

There are a number of transfers, payments, and other items that can be deducted from the gross estate. The deductibility of some transfers are based on the recipient, and the deductibility of some payments (that have been made or are anticipated to be made) depend on state law and the nature of the payment.

A. Marital Deduction

Certain transfers to the surviving spouse qualify for the marital deduction.[136] Such transfers can be the result of a bequest under a Will, an inheritance in accordance with intestate succession, or a non-probate asset's beneficiary designation, among others.[137] There is no limit to the amount of marital deduction that may be taken on the estate tax return, provided all property passing to the surviving spouse does so in qualifying manner. Each of the following conditions must be met for an interest to qualify for the marital deduction: (i) the full value of the property for which the deduction is taken must be included in the gross estate; (ii) the property must pass to the spouse in a qualifying manner; (iii) the property must be a "deductible interest";[138] and (iv) any terminal interest must be "qualified terminal interest property" ("QTIP").[139] See § 2056 and the related regulations for further details on property that qualifies for the marital deduction.

B. Charitable Deduction

The Code authorizes a deduction for transfers to qualifying charitable organizations.[140] In most cases, the value of the deduction must be supported by a qualified appraisal. Other evidence to substantiate the deduction is required, as well. For example, a certified or verified copy of instruments evidencing lifetime charitable donations made by the decedent must be attached to the estate tax return, as well as a written statement of the executor, made under penalties of perjury, stating whether the decedent's Will has been contested in a manner that would affect the charitable deduction and the status of such action.[141]

C. Deductions for Payment of Expenses of Administration, Debts, and Claims

Certain expenses incurred by the estate, debts owed by the decedent, and claims against the decedent can be deducted from the gross estate.[142] Funeral expenses and executors' commissions are deductible expenses of the estate. Expenses of administering the estate include fees for attorneys, accountants, and appraisers. Interest expense incurred after the decedent's death is generally deductible if it is reasonable and necessary to the administration of the estate.[143] The executor can deduct the cost of storing and maintaining estate property, as well as the cost of selling assets in most cases. When community property is involved, only the portion of expenses and debts relating to the decedent's one-half interest in the community property is deductible on the estate tax return. Bona fide debts owed by the decedent at death are deductible from the gross estate. Certain claims against the decedent based on contract and tort law are allowed as a deduction from the gross estate, as discussed below.

[136] *See* I.R.C. § 2056.
[137] *See* I.R.C. § 2056(c).
[138] *See* Treas. Reg. § 20.2056(a)–2.
[139] *See* Treas. Reg. § 20.2056(b)–7.
[140] *See* I.R.C. § 2055.
[141] *See* Treas. Reg. § 20.2055-1(c).
[142] *See* I.R.C. § 2053.
[143] *See* Section VIII.B, *infra*, for the deductibility of interest incurred on a loan taken out to pay estate tax liability.

D. Qualified Appraiser/Appraisal

Certain deductions from the gross estate, such outstanding contract and tort claims (discussed in Sections VI.E.2 and VI.E.3, *infra*, should be supported by a "qualified appraisal" performed by a "qualified appraiser" (discussed above in Section V.E).

E. General Rule: Deductibility

The deduction for any expense, debt, or claim is limited to the "amount actually paid in settlement or satisfaction" of the obligation.[144] Only legally enforceable claims are deductible.[145] Of course, no deduction is allowed to the extent that the estate will be compensated by insurance or otherwise reimbursed.[146] In addition, no estate tax deduction is generally allowed for "potential or unmatured claims"[147] or for "contested claims"[148] (i.e., no deduction for claims against the estate "to the extent the estate is contesting the decedent's liability").[149]

1. Exception: Claim or Expense of Ascertainable Amount that Will Be Paid

"A deduction will be allowed for a claim or expense that satisfies all applicable requirements even though it is not yet paid, provided that the amount to be paid is ascertainable with reasonable certainty and will be paid."[150] For example, executors' commissions and attorneys' fees that have not been paid at the time the Form 706 is filed and that otherwise meet the legal requirements for deductibility may be deducted on Form 706 if they are "ascertainable with reasonable certainty" and "will be paid."[151] However, no deduction is allowed for a "vague or uncertain estimate."[152]

For an example of a claim that was recently found by the Tax Court not to be "ascertainable with reasonable certainty" and, therefore, not deductible by the estate, see *Estate of Saunders v. C.I.R.*[153] On Form 706, the Estate of Gertrude Saunders claimed a deduction in the amount of $30 million for a $90 million lawsuit pending on the date of Mrs. Saunders' death that was ultimately settled for $250,000.[154] Nearly three years later, the IRS sent a Notice of Deficiency to the Estate, denying the deduction.[155] The $30 million deduction was denied on grounds that it was not ascertainable with reasonable certainty as required by the Treasury regulations.[156] The Tax Court pointed to the fact that the experts' valuations of the claim varied widely and held that this constituted "prima facie indication [ ] of the lack of reasonable certainty."[157] In affirming the Tax Court's decision, the Ninth Circuit three-judge panel noted that, although the value of the lawsuit was not deductible on Form 706 because it was not ascertainable with reasonable certainty at the time the Form 706 was filed, the estate could later file a claim for refund and claim a deduction for the amount that the estate ultimately paid to settle the

[144] Treas. Reg. § 20.2053-1(d)(1).

[145] *See* Treas. Reg. § 20.2053-4(d)(4).

[146] *See* Treas. Reg. § 20.2053-1(d)(3). If the potential for reimbursement exists, Form 706 must contain a "reasonable explanation for [the executor's] reasonable determination that the burden of necessary collection efforts in pursuit of a right of reimbursement would outweigh the anticipated benefit from those efforts." *Id.*

[147] Treas. Reg. § 20.2053-4(d)(1).

[148] Treas. Reg. § 20.2053-4(d)(2).

[149] As discussed in the text accompanying Note 158, *infra*, potential, unmatured, and contested claims that later mature may be deducted if a timely claim for refund is filed. *See* Treas. Reg. § 20.2053-4(d)(1)–(2). "To preserve the estate's right to claim a refund for claims that mature and become deductible after the expiration of the period of limitation for filing a claim for refund, a protective claim for refund may be filed." *Id.*

[150] Treas. Reg. § 20.2053-1(d)(4)(i).

[151] *Id.*

[152] *Id.*

[153] *See generally* 136 T.C. 406 (2011) *aff'd*, 745 F.3d 953 (9th Cir. 2014).

[154] *See Estate of Saunders v. C.I.R.*, 745 F.3d 953, 955-56 (9th Cir. 2014).

[155] *Id.* at 956.

[156] *Id.* at 962; *see* Treas. Reg. § 20.2053-1(b)(3).

[157] *Estate of Saunders v. C.I.R.*, 136 T.C. 406, 422 (2011) *aff'd*, 745 F.3d 953 (9th Cir. 2014).

lawsuit.[158] See Section VI.G, *infra* for a discussion of the importance of preserving the estate's right to file a claim for refund in the event that a nondeductible claim such as the one in *Saunders* becomes deductible after the expiration of the period for filing a claim for refund.

Another example of a claim that was not deductible due to its uncertainty is found in *Estate of Foster v. C.I.R.*[159] The Estate of Ellen D. Foster discounted the value of certain assets on its Form 706 for "hazards of litigation."[160] The Estate's alternative position was that the pending litigation was a deductible claim against the Estate.[161] The IRS disallowed the discount "as vague and uncertain estimates that are not ascertainable with reasonable certainty."[162] In Tax Court, the Estate's experts differed in their valuations of the pending lawsuit. The Tax Court judge found that the "sharp discrepancy in their figures evidence[d] a lack of reasonable certainty in the values they suggested."[163] Similar to *Saunders*, in affirming the Tax Court, the Ninth Circuit pointed out that the "sharp discrepancies in expert valuations of the lawsuit" indicated that "the lawsuit's estimated date-of-death value was not ascertainable with reasonable certainty."[164]

2. Exception: Claims and Counterclaims in Related Matter

Subject to certain limitations, a deduction will be allowed for a claim against the estate integrally related to a particular asset included in the gross estate.[165] Similarly, a deduction will be allowed for a counterclaim against the estate related to a cause of action included in the gross estate.[166] In either situation, the current value of the claim may be deducted on Form 706 even if payment has not been made if the following conditions are met:

> (i) Each such claim against the estate otherwise satisfies the applicable requirements set forth in § 20.2053–1; (ii) Each such claim against the estate represents a personal obligation of the decedent existing at the time of the decedent's death; (iii) Each such claim is enforceable against the decedent's estate (and is not unenforceable when paid); (iv) The value of each such claim against the estate is determined from a "qualified appraisal" performed by a "qualified appraiser" within the meaning of section 170 of the Internal Revenue Code and the corresponding regulations; (v) The value of each such claim against the estate is subject to adjustment for post-death events; and (vi) The aggregate value of the related claims or assets included in the decedent's gross estate exceeds 10 percent of the decedent's gross estate.[167]

It is important to note that such deduction is limited to the value of the asset or cause of action to which the claim relates.[168] As discussed in Section VI.F below, post-death events can result in adjustments to deductions for claims against the estate.[169] Post-death events can have a positive or adverse effect on the deductibility of claims. When post-death events result in previously non-deductible claims becoming deductible (both reported claims disallowed by the IRS and those not reported on Form 706), the representative of the estate may file a claim for refund of estate tax paid. To preserve an estate's

[158] *Estate of Saunders v. C.I.R.*, 745 F.3d 953, 962-63 (9th Cir. 2014).
[159] *Estate of Foster v. C.I.R.*, T.C. Memo. 2011-95.
[160] *Id.* at *4.
[161] *Id.* at *8.
[162] *Id.* at *6.
[163] *Id.* at *10.
[164] *Estate of Foster v. C.I.R.*, 565 F. App'x 654, 655 (9th Cir. 2014) cert. denied *sub nom. Bradley v. C.I.R.*, 135 S. Ct. 755, 190 L. Ed. 2d 627 (2014).
[165] Treas. Reg. § 20.2053-4(b)(1).
[166] *Id.*
[167] *Id.*
[168] Treas. Reg. § 20.2053-4(b)(2).
[169] *See* Treas. Reg. § 20.2053-4(b)(3).

right to claim a refund for claims that become deductible after the expiration of the period of limitation for filing a claim for refund, an estate should file a protective claim for refund, discussed in Section VI.G, *infra*.[170]

3. Exception: Certain Contingent Claims Totaling No More than $500,000 in the Aggregate

One or more claims may be deducted on Form 706 even though the claim or claims have not been paid if the following elements are met:

> (i) Each such claim against the estate otherwise satisfies the applicable requirements for deductibility set forth in § 20.2053–1; (ii) Each such claim against the estate represents a personal obligation of the decedent existing at the time of the decedent's death; (iii) Each such claim is enforceable against the decedent's estate (and is not unenforceable when paid); (iv) The value of each such claim against the estate is determined from a “qualified appraisal” performed by a “qualified appraiser” within the meaning of section 170 of the Internal Revenue Code and the corresponding regulations; (v) The total amount deducted by the estate under this paragraph (c) does not exceed $500,000; (vi) The full value of each claim, rather than just a portion of that amount, must be deductible under this paragraph (c) and, for this purpose, the full value of each such claim is deemed to be the unpaid amount of that claim that is not deductible after the application of §§ 20.2053–1 and 20.2053–4(b); and (vii) The value of each claim deducted under this paragraph (c) is subject to adjustment for post-death events.[171]

As with other deductions, post-death events can result in adjustments to deductions for claims against the estate, as discussed in Section VI.F *infra*.[172] If applicable, the representative of the estate should file a protective claim or refund as discussed in Section VI.G, *infra*.

4. Exception: Unpaid Mortgages on Property Included in Gross Estate

The full balance of a mortgage on property included in the gross estate is deductible even it remains unpaid at the time Form 706 is filed, provided the value of the property (without respect to the mortgage) is included in the gross estate.[173] Interest accrued on the mortgage as of the date of death is deductible, as well.[174] The date-of-death cut-off applies for deduction of accrued interest even if the alternate valuation date is selected.[175]

F. Effect of Post-Death Events on Deductions from Gross Estate

Deductions for expenses, debts, and claims of the estate “will be allowed to the extent the Commissioner is reasonably satisfied that the amount to be paid is ascertainable with reasonable certainty and will be paid.”[176] “In making this determination, the Commissioner will take into account events occurring after the date of a decedent's death.”[177] For example, the reimbursement (by insurance or otherwise) of an expense or claim may result in the reduction or complete disallowance of the deduction reflected on Form 706.[178] “The difference between a deduction for an uncertain claim and one for the

[170] *See id.*
[171] Treas. Reg. § 20.2053-4(c)(1).
[172] *See* Treas. Reg. § 20.2053-4(c)(2). For examples helpful to understanding which claims fall under this exception, see Treas. Reg. § 20.2053-4(c)(3).
[173] *See* Treas. Reg. § 20.2053-7.
[174] *See id.*
[175] *See id.*
[176] Treas. Reg. § 20.2053-1(d)(4)(ii).
[177] *Id. See also* Treas. Reg. § 20.2053-1(d)(2).
[178] *See* Treas. Reg. § 20.2053-1(d)(3).

amount ultimately paid can be substantial."[179] The difference between the expected outcome and the ultimate outcome can be a result of factors such as a surprisingly high jury verdict or an agreement to settle for less than anticipated. A settlement may be relied on to establish the amount of a contingent claim that is otherwise deductible provided the claim is enforceable and the settlement "resolves a bona fide issue in a genuine contest and is the product of arm's-length negotiations by parties having adverse interests with respect to the claim or expense."[180]

More than a decade ago, the Fifth Circuit reversed the Tax Court in *Estate of Smith* and held that post-death events were irrelevant when it came to deductions for contingent or disputed claims against the decedent's estate.[181] The service disagreed and announced its "[n]onacquiescence relating to whether post-death events should be considered in determining the amount deductible under Internal Revenue Code section 2053(a)(3) for claims against the estate that are contigent [sic] or contested at the date of death."[182] Regulations promulgated in 2009 provide that deductions for uncertain claims against the estate should be adjusted for post-death events.

The position set forth in some recent case law is that post-death events do not impact deductions for claims that are "certain and enforceable." For example, the Ninth Circuit recently held in *Marshall Naify Revocable Trust v. United States* that "an estate cannot look to post-death events when valuing a claim against the estate that is certain and enforceable as of the date of death."[183] However, the decedent in *Marshall* died in 2000.[184] The current regulations, which apply to the estates of decedents dying on or after October 20, 2009, state that "[i]n determining whether and to what extent a deduction under section 2053 is allowable, events occurring after the date of a decedent's death will be taken into consideration"[185] and "[e]vents occurring after the date of a decedent's death shall be considered in determining whether and to what extent a deduction is allowable under section 2053."[186] In addition, as demonstrated by *Estate of Saunders*, discussed previously in Section VI.E.1, "post-death events *are* relevant when computing the deduction to be taken for disputed or contingent claims" and "courts may 'consider post-death events when valuing a disputed or contingent claim against an estate.'"[187]

G. Protective Claim for Refund

When a deduction for a claim or expense reported on Form 706 that has not yet been paid is disallowed by the Commissioner on grounds that it does not meet the elements for deductibility (i.e., ascertainable with reasonable certainty and will be paid), or when such a deduction is not claimed on Form 706 in the first place for the same reason, the estate can file a claim for refund if the claim or expense subsequently is paid or later satisfies elements for deductibility.[188] "To preserve the estate's right to claim a refund for amounts becoming deductible after the expiration of the period of limitation for the filing of a claim for refund, a protective claim for refund may be filed."[189] To be effective, a protective claim for refund must be filed prior to the expiration of the period of limitations for filing a claim for

[179] Planning an Estate: A Guidebook of Prin. & Tech. § 2:20 (4th ed.).

[180] Treas. Reg. § 20.2053-1(b)(3)(iv). *See generally Estate of Saunders v. C.I.R.*, 136 T.C. 406, 422 (2011) *aff'd*, 745 F.3d 953 (9th Cir. 2014) ($250,000 settlement allowed as a deduction for lawsuit which the estate had originally valued at $30 million).

[181] *Estate of Smith v. C.I.R.*, 198 F.3d 515 (5th Cir. 1999), *nonacq., IRS Announcement Relating to: Smith*, 2000-19 I.R.B. 01 (IRS ACQ 2000) and *nonacq. recommended by* I.R.S. AOD- 2000-04 (IRS AOD May 8, 2000).

[182] *IRS Announcement Relating to: Smith*, 2000-19 I.R.B. 01; *See* I.R.S. AOD-2000-04 (May 8, 2000) ("We nonacquiesce in the Fifth Circuit's opinion that disputed claims against the estate at the date of death are to be valued without reference to post-death events.").

[183] 672 F.3d 620, 627 (9th Cir. 2012) (citing *Propstra v. United States*, 680 F.2d 1248, 1254 (9th Cir. 1982)).

[184] *Id.* at 621.

[185] Treas. Reg. § 20.2053-1(d)(2).

[186] Treas. Reg. § 20.2053-4(a)(2).

[187] *Estate of Saunders v. C.I.R.*, 745 F.3d 953, 958 (9th Cir. 2014).

[188] Treas. Reg. § 20.2053-1(d)(4)(ii).

[189] *Id.*

refund (the later of three years after the return is filed or two years after the tax is paid).[190] Revenue Procedure 2011-48 provides instructions for filing a protective claim for refund.[191] A claim is made by filing Schedule PC, "Protective Claim for Refund," with Form 706. Alternatively, a claim can be made by filing Form 843, "Claim for Refund and Request for Abatement." With either method, a separate schedule or form must be filed for each claim. When a protective claim for refund is properly filed and the claim to which it relates ripens and becomes ready for consideration outside of the period of limitation for assessment, the Service will generally limit the scope of its review of the Form 706 to evidence relating to the deduction that was the subject of the protective claim for refund.[192]

VII. GIFTS MADE DURING DECEDENT'S LIFETIME

A. Lifetime Gifts Included in Estate Tax Calculation

Taxable lifetime gifts made by the decedent are added to the decedent's taxable estate (i.e., the gross estate minus deductions) to arrive at the sum to which the tax rate is applied from the table shown in Section IV.C, *supra*. Therefore, it is imperative for the executor to obtain accurate information regarding lifetime gifts made by the decedent.

B. Obtaining Copies of Tax Returns from the IRS

Copies of all gift tax returns filed by the decedent must be attached to the estate tax return. However, gift tax returns filed by the decedent may not be readily accessible to the executor. Fortunately, the Code provides that, upon written request, the IRS shall make copies of a deceased person's tax returns made available to the administrator, executor, or trustee of the deceased person's estate.[193] To request a copy of gift tax returns filed by the decedent, the executor should submit Form 4506, "Request for Copy of Tax Return" (and allow plenty of time for processing!). When this method is used to obtain copies of the decedent's gift tax returns from the IRS, the special discharge of liability discussed below in Section X.B.2 will be available to the executor.

VIII. PAYING THE ESTATE TAX

"The wages of sin are death, but by the time taxes are taken out, it's just sort of a tired feeling."
~ Paula Poundstone

The estate tax is due nine months from the date of death. This is true even if the executor has extended the deadline for filing. Paying the estate tax may be a concern for some executors, especially executors of estates that are "property rich" but "cash poor." It may also be a concern for executors of estates consisting mainly of closely held business entities. When sufficient cash is not available to pay the estate tax, executors have a number of options.

A. Liquidation

Estate assets may be sold to raise money to pay the tax. However, the forced sale of assets in order to make the payment deadline may result in the assets being sold at below-market prices. The executor must assess the risks and benefits involved in selling assets at sacrifice prices versus penalties and interest that may be imposed by the IRS. In some cases, it may be advisable for the executor to seek an extension of time to pay, covered above in Section IV.C.2.

[190] Treas. Reg. § 20.2053-1(d)(5)(i).
[191] *See* Rev. Proc. 2011-48, 2011-42 I.R.B. 527.
[192] *See id.*; Notice 2009-84, 2009-44 I.R.B. 592.
[193] *See* I.R.C. § 6103(e)(3)(A).

B. Loan

Estate assets may be used as collateral for a loan to pay the tax. Interest on borrowed funds are generally deductible as an administration expense if it involves an ascertainable amount of interest paid on a bona fide loan that was necessary due to the illiquid nature of the estate. The Tax Court has held that interest expense incurred on a loan for payment of estate tax is deductible where a "liquidity dilemma"[194] exists or when it is necessary to "avoid a forced sale"[195] of estate assets. In *Estate of Duncan v. C.I.R.*, the court held that the estate's interest expense on funds borrowed to pay the estate tax was deductible as an administration expense "because the loan was genuine indebtedness, the interest expense was actually and necessarily incurred in the administration of the Estate, and the amount of interest was ascertainable with reasonable certainty."[196] For deductibility of estimated future interest payments, see Revenue Ruling 84-75.[197]

C. Extension of Time To Pay or Deferred Payment

Some estates may qualify for an extension of time to pay, covered in Section IV.C.3, above, or a deferred payment plan for the estate tax relating to closely held businesses owned by the estate, as discussed in Section IV.C.4, above.

IX. PENALTIES

"The only difference between death and taxes is that death doesn't get worse every time Congress meets."
~ Will Rogers

A. Failure To File

If Form 706 is not filed by its due date (including any extension), § 6651 imposes a penalty on the estate equal to five percent of the estate tax due for each month (or portion of a month) that the tax remains unpaid, not to exceed 25 percent of the tax due in the aggregate.[198] This is a non-delegable duty of the executor, and circumstances such as the unavailability of information needed to prepare the return, pending litigation that may significantly affect estate assets, or the executor's lack of knowledge that a return is required to be filed are no excuse.[199]

B. Failure To Pay

If the estate tax is not paid on or before the deadline for filing Form 706 (NOT including any extensions of time to file!), § 6651 imposes a penalty equal to 0.5 percent of the amount of tax shown on the return (or the amount that should have been shown on the return) for each month or fraction of a month that it remains unpaid, but not to exceed 25 percent in the aggregate."[200] The penalty is increased to one percent per month if the tax remains unpaid after notice and demand from the IRS.

Failure to pay the estate tax in full can result from a number of circumstances. For example, the understatement of the value of assets or the overstatement of the value of deductions can affect the estate tax calculation in such a way that the tax as finally determined is underpaid. Similarly, the discovery of unreported assets or the Service's failure to accept the value of assets or deductions reported on the return can also result in adjustments to the estate tax liability.

[194] *Estate of Black v. C.I.R.*, 133 T.C. 340, 385 (2009).
[195] *Estate of Graegin v. C.I.R.*, 56 T.C.M. (CCH) 387 (T.C. 1988).
[196] T.C. Memo. 2011-255.
[197] Rev. Rul. 84-75, 1984-1 C.B. 193.
[198] Treas. Reg. § 301.6651-1(a)(1).
[199] *See generally Thomas v. C.I.R.*, T.C. Memo. 2001-225.
[200] Treas. Reg. § 301.6651-1(a)(2); Treas. Reg. § 301.6651-1(a)(3).

C. The Reasonable Cause

An exception exists for situations where the failure to timely file Form 706 or pay the estate tax is "due to reasonable cause and not to willful neglect."[201] A taxpayer who wishes to avoid failure-to-file or failure-to-pay penalties must "make an affirmative showing of all facts alleged as a reasonable cause for his failure to file such return or pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury."[202]

1. Reasonable Cause for Failure To File

a. Ordinary Business Care and Prudence

An executor may be able to escape the failure-to-file penalty on the basis of "reasonable cause" if the executor "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time.[203]

b. Reliance on Experts

Reliance on a tax professional's erroneous advice about procedural issues, such as deadlines for filing tax returns, does not fall under the "reasonable cause" exception. In *Knappe v. United States*, the executor retained a certified public accountant to prepare the estate tax return.[204] In the course of the engagement, the executor asked the CPA to prepare and file Form 4768.[205] The CPA did so, requesting an extension for both filing the estate tax return and paying the estate tax. The IRS approved the extension request, extending the deadline for filing by six months (the maximum allowed) and the deadline for payment by one year.[206] For reasons that are not clear, the CPA mistakenly believed that the IRS had granted a one-year extension of the filing deadline, even though this would not be allowed under the regulations. Acting on the advice of his CPA, the executor filed the estate tax return three months late. Because the estate tax return was not timely filed, the IRS assessed a substantial late-filing penalty under § 6651(a).[207] The executor disputed the late-filing penalty in district court, arguing that his reliance on his CPA's advice regarding the extension of the filing deadline constituted reasonable cause under § 6651(a)(1). The district court granted summary judgment in favor of the IRS on grounds that the executor's reliance on the CPA's advice was "insufficient to establish reasonable cause."[208] The U.S. Court of Appeals for the Ninth Circuit reasoned that the case turned on whether the CPA's erroneous advice constituted substantive or procedural tax law and concluded that "the question of when a return is due—even when an executor has sought an extension—is nonsubstantive" and "[r]eliance on erroneous advice about nonsubstantive tax law issues cannot constitute reasonable cause for an executor's failure to file a timely return."[209] According to the court, the executor "did not exercise ordinary business care and prudence when he relied unquestioningly on [the CPA's] advice about the extended deadline, and he unreasonably abdicated his duty to ascertain the filing deadline and comply with it."[210] The court placed the blame squarely on the executor, saying that it was the executor's "duty to ascertain the correct extended filing deadline. By relying on his accountant's advice about that nonsubstantive matter, he failed to exercise ordinary business care and prudence, and he cannot show reasonable cause to excuse the penalty."[211] Affirming the lower court's decision, the appellate court acknowledged that "the result today

[201] *Id.*
[202] Treas. Reg. § 301.6651-1(c)(1).
[203] *Id.*
[204] 713 F.3d 1164, 1166 (9th Cir. 2013), cert. denied, 134 S. Ct. 422, 187 L. Ed. 2d 280 (2013).
[205] *Id.* at 1166.
[206] *Id.* at 1167.
[207] *Id.*
[208] *Id.*
[209] *Id.* at 1173-74.
[210] *Id.* at 1171.
[211] *Id.* at 1175.

imposes a heavy burden on executors, who will affirmatively have to ensure that their agents' interpretations of filing and payment deadlines are accurate if they want to avoid penalties. This burden is justified by the government's substantial interest in ensuring that returns are timely filed."[212]

Even in extreme cases of preparer malpractice, courts have held firm to the position that the responsibility to timely file tax returns is a non-delegable duty of the executor of the estate and reliance on a preparer to file a return or pay tax does not constitute reasonable cause.[213] In *Specht v. United States*, an elderly and unsophisticated executor hired an attorney to prepare the required federal and state estate tax returns and to prepare the documents needed to administer the decedent's estate.[214] The estate was worth approximately $12.5 million. The attorney, who was suffering from brain cancer and was later declared incompetent, failed to prepare the required federal and state tax returns. As a result, the federal and state estate tax returns were not timely filed and the federal and state estate taxes were not timely paid. The IRS assessed failure-to-file and failure-to-pay penalties of more than $1 million. The State of Ohio assessed late-filing and late-payment penalties as well, but later refunded the penalties presumably due to the attorney's outrageous conduct.[215] When the case went to court, the executor asked for forgiveness of the hefty federal penalties on grounds that reasonable cause existed because the attorney on whom she relied to handle the estate turned out to be physically incompetent. The court observed that the State of Ohio had mercifully refunded the penalties for Ohio estate taxes and chastised the IRS for not doing the same.[216] However, the court acknowledged that "the reasonable cause analysis looks at the party with ultimate responsibility for satisfying the tax liabilities, not the actions or medical conditions of their agent."[217] Although the court clearly balked at doing so, it held in favor of the IRS, stating that "While this Court finds it difficult to hold that Plaintiffs are ultimately responsible for [the attorney's] malpractice, that is what binding precedent requires."[218]

2. Reasonable Cause for Failure To Pay

a. Ordinary Business Care and Prudence + Inability To Pay or Undue Hardship

"A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date."[219] "Undue hardship" means that "substantial financial loss . . . will result to the taxpayer."[220] "In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence . . . consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. Thus, for example, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability."[221] "A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets

[212] *Id.* at 1174.
[213] *See generally Specht v. United States*, No. 1:13-CV-705, 2015 WL 74539 (S.D. Ohio Jan. 6, 2015).
[214] *See id.* at *1.
[215] *Id.* at *7.
[216] *Id.* ("Notably, in light of [the attorney's] malpractice, the State of Ohio refunded the late filing and payment penalties for Ohio estate taxes . . . It is truly unfortunate that the United States did not follow the State of Ohio's lead.").
[217] *Id.* at *6.
[218] *Id.*
[219] Treas. Reg. § 301.6651-1(c)(1).
[220] Treas. Reg. § 1.6161–1(b).
[221] Treas. Reg. § 301.6651-1(c)(1).

in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due."[222]

b. Reliance on Experts

Reliance on a tax professional to take care of procedural matters, such as filing extension requests, does not fall under the "reasonable cause" exception. Remember, filing tax returns and extension requests are non-delegable duties![223] In *Baccei v. United States* (discussed in Section IV.C.3.b, *supra*), the executor relied on his CPA to request an extension of time to pay the estate tax.[224] The CPA filed Form 4768 on time, but he did not fill out the section of the form relating to extension of time to pay.[225] Taking the position that no extension for time to pay was requested, the IRS assessed the failure-to-pay penalty on the estate. In district court, the executor argued that "reasonable cause existed excusing his failure to timely pay the estate taxes, as he reasonably relied upon his accountant to obtain the payment extension."[226] The executor reasoned that "he exercised ordinary business care and prudence in relying on a 'well-qualified and knowledgeable CPA' to request and obtain a payment extension."[227] In ruling against the executor, "the district court held that '[a]n individual's duty to file tax returns . . . or pay taxes under 26 U.S.C. § 6651(a) cannot be delegated, and reliance on a third party, even a CPA, is not 'reasonable cause' for late filing.'"[228] The district court further held that it was the executor's responsibility "'to ascertain the [payment] due date, and to make certain that a proper request for late payment had been made.'"[229] On appeal, the Ninth Circuit affirmed the district court's decision, explaining that "a taxpayer 'cannot rely on its employee or agent to escape responsibility for the nonperformance of nondelegable tax duties'"[230] The appellate court agreed with the lower court's finding that the executor's reliance on the CPA "to competently file a payment extension request does not constitute reasonable cause excusing [the executor's] failure to timely pay the estate taxes owed. Although [the executor] was entitled to retain an accountant to seek a payment extension, [the executor] was responsible for either identifying the payment deadline and ensuring that payment was made prior to that deadline, or confirming that a payment extension had been properly requested and granted. By failing to confirm that an extension had been requested and granted before the payment deadline lapsed, [the executor] failed to exercise the 'ordinary business care and prudence' necessary to establish reasonable cause."[231]

c. Relationship Between § 6651 Excuse for Late Payment and § 6161 Extension

As mentioned previously in Section IV.C.3.a, the elements required for the excuse for late payment under § 6651 are intertwined with the elements required to qualify for the § 6161 extension of time to pay covered in Section IV.C.2, *supra*. *Estate of Hartsell v. C.I.R.*, discussed above in Section IV.C.3.a in the context of the § 6161 extension of time to pay, provides numerous examples of what not to do when

[222] *Id.*
[223] *See United States v. Boyle*, 469 U.S. 241, 252 (1985).
[224] 632 F.3d 1140, 1143 (9th Cir. 2011).
[225] *Id.* at 1143.
[226] *Id.* at 1144.
[227] *Id.*
[228] *Id.*
[229] *Id.*
[230] *Id.* at 1148 (9th Cir. 2011) (quoting *Conklin Bros. of Santa Rosa, Inc. v. United States,* 986 F.2d 315, 319 (9th Cir. 1993)).
[231] *Id.* at 1148-49. In contrast, the court in *Estate of Thouron* distinguished between reliance on a tax professional for clerical actions (such as the filing of a timely return or extension) and reliance on a tax professional's expert advice. *See Estate of Thouron v. United States*, 752 F.3d 311, 315 (3d Cir. 2014). The court in *Thouron* held that a taxpayer's reliance on the substantive advice of a tax professional may constitute reasonable cause for failure to pay if the other statutory requirements are met. *Id.*

trying to obtain relief for late payment under § 6651.[232] In *Estate of Hartsell,* the majority of the estate was comprised of nonliquid assets.[233] The executor obtained two § 6161 extensions of time to pay, but was denied his request for a third extension. The case went to the Tax Court when the IRS assessed additional tax on the estate under § 6651 for the unpaid estate tax. When the executor claimed that the additional tax should not be assessed because the estate's failure to pay the tax was due to reasonable cause and not due to willful neglect, the court enumerated a number of reasons why the estate failed to qualify for the "reasonable cause" exception. The court noted that a "taxpayer bears a "heavy burden" of proving both that the failure was due to reasonable cause and not willful neglect"[234] and "[f]ailure to pay timely is due to 'reasonable cause' if the taxpayer exercised ordinary business care and prudence and was nevertheless unable or would suffer an undue hardship to pay the tax by the due date."[235] Since the estate in *Hartsell* contained few liquid assets from which to pay its estate tax liability, the executor had to look to other methods to raise the funds to pay the tax. The court acknowledged that "consideration will be given to all the facts and circumstances of the taxpayer's financial condition in determining whether the taxpayer was unable to pay despite the exercise of ordinary business care and prudence."[236] The executor claimed he tried to raise funds by liquidating estate assets. However, according to the court, the executor's feigned attempts at liquidating estate assets did not pass muster.

> [The executor] chose to sell a mere five properties from an estate composed of more than 60 properties. He advertised the properties by placing a single 'for sale' sign on each with a phone number. . . . One person contacted the estate regarding a property but expressed no interest upon hearing the asking price. [The executor] did not enlist the assistance of a professional real estate broker and instead relied on his own expertise and that of a small team, which included his two sons. [He] attributes his lack of success in selling the estate's five properties to macroeconomic events including a slowing economy, the national recession beginning March 2001, the collapse of Enron, the State and national declines in real income, the evaporation of stock investor wealth, and even the uncertainties of war in Afghanistan and Iraq and the events of September 11, 2001. . . . Rather, we attribute the lack of interest in the estate's properties to its arbitrary prices, negligible marketing efforts, too few properties advertised, a desire to save paying third parties other than [the executor] and his sons, and, overall, a desire to sell at a profit rather than at current market prices. . . . We find that the estate did not adequately determine reasonable prices at which the five advertised properties could sell. Asked how prices were calculated, [the executor] stated simply that he put a figure on them and waited for an offer to come along. One witness for the estate testified that little research was conducted to ascertain proper sales prices and that [the executor] would merely declare a price and place a 'for sale' sign on the property. . . . The estate's failure to list properties with a realty company before the due date also exhibits a lack of ordinary business care and prudence. . . . A more prudent course would have been to hire a realty company when it became apparent the five properties advertised for sale would not sell by the payment due date.[237]

The executor also claimed he tried to borrow the funds to pay the estate tax. However, he made only two informal inquiries into obtaining a loan and offered only a single piece of property as collateral. According to the court, the executor's two informal inquiries were "inadequate to prove ordinary business

[232] *See generally* T.C. Memo. 2004-211.
[233] *Id.*
[234] *Id.* (quoting *United States v. Boyle*, 469 U.S. 241, 245, 105 S.Ct. 687, 83 L.Ed.2d 622 (1985)).
[235] *Id.* (citing *United States v. Boyle*, 469 U.S. 241, 246, 105 S.Ct. 687, 83 L.Ed.2d 622 (1985)).
[236] *Id.*
[237] *Id.*

care and prudence."[238] The court further noted that "no effort [was made] to sell or borrow against the estate's mineral interests or its portfolio of stocks and bonds," calling such inaction "additional indicium that the estate failed to exercise ordinary business care and prudence in attempting to pay its Federal estate tax."[239] As additional evidence of the executor's lack of ordinary business care and prudence in attempting to pay the estate tax, the court pointed out that, despite the estate tax being unpaid, the executor paid himself fees of nearly $1 million dollars out of the estate and forgave two debts totaling close to $1 million owed to the estate by the executor and his son.[240] The lesson to learn from *Estate of Hartsell* is that an executor must make a bona fide effort to raise funds to pay the estate tax in order to qualify for relief under § 6651. A half-hearted or sham attempt will not satisfy the "ordinary business care and prudence" requirement.

X. LIABILITY FOR PAYMENT OF ESTATE TAX AND PENALTIES

"I think everything about estate tax liens is confusing."
~ IRS Chief Counsel Advisory 201418048 (May 2, 2014).

A. *Estate Tax Lien*

The Code imposes a special estate tax lien upon the assets included in a decedent's gross estate.[241] This special lien attaches automatically at the date of death and lasts for ten years"[242] The lien attaches to "every part of the gross estate, whether or not the property comes into possession of the duly qualified executor or administrator."[243] Therefore, both probate and non-probate property are subject to the special estate tax lien. The amount of the special lien includes the estate tax shown to be due on Form 706 plus any deficiency in tax found to be due upon review and audit.[244] In other words, the lien serves to secure the amount of estate tax that is ultimately owed by the estate.

B. *Personal Liability of Executor*

"A representative of . . . an estate . . . paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government."[245] Therefore, an executor risks personal liability for unpaid estate tax if assets are distributed to beneficiaries or estate creditors without sufficient assets being retained from which to pay the estate tax. The case of *United States v. Whisenhunt* illustrates the potential consequences of distributing assets from an estate prior to paying the estate tax.[246] Dr. Jacob Lindy Kay died in 2002, and the majority of his estate's assets were distributed shortly thereafter. For reasons that are unclear, the executor failed to file Form 706 until nearly five years after Dr. Kay's death. A payment of almost $400,000 for estate tax and accrued interest was submitted along with the late estate tax return. Soon after the Form 706 was filed, the Service assessed failure-to-file and failure-to-pay penalties against the estate and issued a notice of intent to levy to the executor of the estate. A few months later, the beneficiaries of the estate entered into a "family settlement and distribution agreement" whereby estate assets totaling 190,000 would be distributed among the beneficiaries.[247] In February of 2012, the Service sued the executor of the estate (along with

[238] *Id.*
[239] *Id.*
[240] *Id.* The court also noted that, although the issue had not been raised, there was a strong argument that the executor had breached his fiduciary duties in this case. *Id.*
[241] I.R.C. § 6324(a)(1). However, the part of the gross estate used to pay court-authorized charges against the estate and court-authorized expenses of administration is exempt from the special estate tax lien.
[242] *Id.*
[243] Treas. Reg. § 301.6324-1(a)(1).
[244] *Id.*
[245] 31 U.S.C.A. § 3713.
[246] *See generally* No. 3:12-CV-0614-B, 2014 WL 3610792 (N.D. Tex. July 21, 2014).
[247] *Id.*

the beneficiaries of the estate) for unpaid estate tax, penalties, and interest totaling close to $200,000, seeking judgment against the executor individually and in his capacity as executor of the estate.[248] The Court entered default judgment against the executor in his capacity as executor of the estate and noted that his "failure to fully pay the Estate's federal estate tax and penalties constituted a violation of his statutory duties under 31 U.S.C. § 3713 as well as a violation of his fiduciary duties under Texas law."[249] "Consequently, the Court also ordered [the executor], in his personal capacity, jointly and severally liable to the United States for payment of the judgment."[250]

1. Discharge of Personal Liability

The Code provides a means by which an executor can obtain a discharge of personal liability for estate tax.[251] To obtain a discharge of personal liability, the executor may submit a written application to the IRS requesting a determination of the amount of estate tax due.[252] Within nine months after receipt of the application or within nine months after the return is filed, whichever is later, the IRS will notify the executor of the amount of the estate tax.[253] Once the estate tax reflected in the notice is paid in full, the executor is discharged from personal liability of any deficiency that is later assessed.[254] The regulations clarify that the discharge "applies only to [the executor] in his personal capacity and to his personal assets. The discharge is not applicable to his liability as executor to the extent of the assets of the estate in his possession or control. Further, the discharge is not to operate as a release of any part of the gross estate from the lien for estate tax for any deficiency that may thereafter be determined to be due."[255]

The application may be made using Form 5495, "Request for Discharge From Personal Liability Under Internal Revenue Code Section 2204 or 6905," which pertains to income, gift, and estate taxes.

2. Good Faith Reliance on Gift Tax Returns Furnished by the IRS

If the executor relies in good faith on copies of gift tax returns obtained from the IRS pursuant to § 6103(e)(3) (see Section VII.B, *supra*) for determining the decedent's taxable gifts for purposes of calculating the estate tax liability, the executor "shall be discharged from personal liability with respect to any deficiency of the tax . . . which is attributable to adjusted taxable gifts which . . . [were] made more than 3 years before the date of the decedent's death, and . . . are not shown on such returns."[256] The executor remains liable for gifts made within three years of the decedent's death and for unreported taxable gifts (made at any time during the decedent's life) of which the executor had actual knowledge.

C. Personal Liability of Transferee of Non-Probate Property

The Code imposes personal liability for unpaid estate taxes on a "spouse, transferee, trustee . . . surviving tenant, person in possession, . . . or beneficiary," who receives non-probate property as a result of the decedent's death or has in his or her possession non-probate property on the date of the decedent's death.[257] Texas law includes a similar provision.[258] The generally applicable statute of

[248] Relevant to this analysis, the Service sought judgment against the estate under § 6651(a)(1), judgment against the executor in his capacity as executor of the estate under § 7402 and personally for fiduciary liability under 31 U.S.C. § 3713 and Texas law.

[249] *Id.*

[250] *Id.*

[251] *See* I.R.C. § 2204.

[252] *See* Treas. Reg. § 20.2204-1(a).

[253] If the executor never receives a notice from the IRS, he or she is still discharged at the end of the nine-month period from any future deficiency. *See id.*

[254] Special rules exist for when extensions under § 6161 or § 6166 are in place. *See* Treas. Reg. § 20.2204-1(b).

[255] *Id.*

[256] I.R.C. § 2204(d).

[257] *See* I.R.C. § 6324(a)(2). Such non-probate property includes, among other things, annuities, assets owned as joint tenants with right of survivorship, and life insurance proceeds. *See* I.R.C. §§ 2034 to 2042.

limitations found in § 6502 applies to transferee liability rather than the period applicable to the special estate tax lien discussed in Section X.A, *supra*. While the special estate tax lien of § 6324(a)(1) expires ten years after the date of the decedent's death, the transferee liability that arises under § 6324(a)(2) does not.[259] Instead, the transferee liability that arises under § 6324(a)(2) is subject to collection during the ordinary collection period of ten years from the date of assessment of the tax.[260] The term "tax" includes penalties such as the penalties for late filing of Form 706 and late payment of estate tax.[261]

The Tax Court recently held that the IRS may collect estate tax from a transferee of estate assets without a prior assessment against the transferee (i.e., the one-step process contemplated by § 6324 is not hampered by the limitations set forth in § 6901).[262] Dr. Mangiardi died in 2000 with a taxable estate consisting mostly of non-probate assets.[263] More than 99 percent of the gross estate was made up of individual retirement accounts and a revocable trust established by Dr. Mangiardi during his lifetime. Upon Dr. Mangiardi's death, the retirement accounts passed to his nine children pursuant to state law and the trust became irrevocable. Neither the retirement accounts nor the trust were subject to disposition through probate. The executor (who was also the trustee of Dr. Mangiardi's trust) timely filed Form 706 but did not pay the $2.6 million estate tax liability. On the Form 706, she explained the reason for nonpayment as being that "most of decedent's assets were not subject to distribution thorough probate."[264] The executor requested and the Service granted a number of extensions for payment of the estate tax.[265] The letter from the Service granting the executor's final extension request warned that, if the estate tax was not paid by the deadline granted in the final extension, "the IRS will begin making transferee assessments against the heirs of the estate that received assets and have not paid to the IRS their portion of the estate tax and interest owed."[266] The estate tax remained unpaid, and the Service initiated collection actions peppered with a number of blunders not pertinent to this analysis. According to the court, there appears to have been a reasonable basis for such collection activity, given that Dr. Mangiardi's nine children had received distributions totaling more than $3.4 million from his retirement accounts at his death.[267] The executor argued, among other things, that the Service was unable to "collect from the beneficiaries through an action in equity under section 6324(a)(2) because the statute of limitations for making a transferee assessment under section 6901 ha[d] expired."[268] While the court expressed sympathy for "the beneficiaries of decedent's estate in that years later they find themselves at risk of forfeiting their inheritance without prior notice, especially after [the IRS] had ample opportunity to make assessments against them," it ultimately held that a § 6901 assessment is not required before initiating a collection action under § 6324(a)(2).[269]

[258] *See* TEX. ESTATES CODE § 124.015 ("A representative shall recover from any person interested in the estate the unpaid amount of the estate tax apportioned and charged to the person under this subchapter unless the representative determines in good faith that an attempt to recover the amount would be economically impractical.").

[259] INTERNAL REVENUE MANUAL § 5.17.2.9.1 (Dec. 12, 2014). *See also* Treas. Reg. § 301.6901–1.

[260] *See United States v. Kulhanek*, 755 F. Supp. 2d 659, 663 (W.D. Pa. 2010). The court in *Kulhanek* also noted that the ten-year § 6502(a)(1) statute of limitations applicable to transferee liability can be suspended or extended, unlike the absolute ten-years-from-date-of-death lien period applicable to the special estate tax lien of § 6324(a)(1). *Id.* *See also* I.R.C. § 6901(h) ("the term 'transferee' includes donee, heir, legatee, devisee, and distributee, and with respect to estate taxes, also includes any person who, under section 6324(a)(2), is personally liable for any part of such tax").

[261] *See* I.R.C. § 6665(a).

[262] *See generally Estate of Mangiardi v. C.I.R.*, T.C. Memo. 2011-24 *aff'd*, 442 F. App'x 526 (11th Cir. 2011).

[263] *Id.* at *1.

[264] *Id.*

[265] *Id.* at *2–*3.

[266] *Id.*

[267] *Id.* at *6.

[268] *Id.*

[269] *Id.* at *5.

United States v. Whisenhunt, discussed in Section X.B, *supra*, is an example of a case where transferee liability came back to haunt a beneficiary of an estate. A certain beneficiary by the name of John Frederick Volker received $596,506.50 from the estate of Dr. Jacob Lindy Kay ($70,000.00 in cash and $526,506.50 from an IRA).[270] The majority of the estate's assets were distributed to the estate's beneficiaries without the estate's tax liability being paid in full. In February of 2012, the Service sued the executor of the estate and Mr. Volker (along with several other named defendants) for unpaid estate tax, penalties, and interest totaling close to $200,000. By this time, the executor appeared to be out of the picture (perhaps due to a disability),[271] and the focus of the case shifted to Mr. Volker since he had received the largest portion of the estate's assets.[272] With respect to Mr. Volker, the Service sought foreclosure of federal tax liens under § 6324(a)(1) and judgment against him in his capacity as a beneficiary of the estate under § 6324(a)(2).[273] The Service moved for final judgment against Mr. Volker on grounds that he was "personally liable under § 6324(a)(2) for the estate's unpaid tax obligations up to $526,506.50, the value of his IRA distribution at the time of decedent's death."[274] The court pointed out that the key elements of the case giving rise to Mr. Volker's transferee liability were undisputed: namely, that Mr. Volker received a distribution from the estate having a value of $526,506.50 as of Dr. Kay's death, Mr. Volker received the distribution before the federal estate tax was paid; and the estate still had outstanding federal tax obligations totaling nearly $200,000.[275] Accordingly, the court concluded that Mr. Volker was personally liable under § 6324(a)(2) for the estate's tax liability up to $526,506.50[276] and granted the Service's motion for final judgment against Mr. Volker.[277]

The federal statute purports to limit a transferee's personal liability to "to the extent of the value, at the time of the decedent's death, of such property" received by the transferee.[278] However, the Fifth Circuit recently held that the transferee's personal liability under § 6324 is not limited by the date-of-death value of the property received by the transferee! In *United States v. Marshall*, the IRS assessed liability for unpaid gift tax against donees pursuant to § 6324(b).[279] However, rather than capping the donees' liability at the value of the gift at the time of donation, the IRS asserted it could "charge interest pursuant to I.R.C. §§ 6601 and 6621 on the unpaid donee liability created by § 6324(b)."[280] The IRS reasoned that "there were two separate obligations: the obligation of the donor and the obligation of the donee. Section 6324(b), according to the [IRS], only limited the obligation of the donor, and so the donee's liability for the unpaid gift tax was not capped under § 6324(b)."[281] As would be expected, the donees argued that "the plain language of § 6324(b) capped all donee liability at the value of the gift received, and so the donees could not incur unlimited interest on any separate donee liability."[282] The Tax Court held in favor of the IRS. Despite Circuit Judge Priscilla Owen's well-reasoned five-page

[270] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226000, at *1 (N.D. Tex. Feb. 28, 2014) report and recommendation adopted in part, rejected in part, No. 3:12-CV-0614-B, 2014 WL 1226177 (N.D. Tex. Mar. 25, 2014).

[271] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 3610792, at *4 (N.D. Tex. July 21, 2014).

[272] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226177, at *2 (N.D. Tex. Mar. 25, 2014).

[273] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226177, at *1 (N.D. Tex. Mar. 25, 2014); *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226177, at *1 (N.D. Tex. Mar. 25, 2014).]

[274] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226000, at *4 (N.D. Tex. Feb. 28, 2014) report and recommendation adopted in part, rejected in part, No. 3:12-CV-0614-B, 2014 WL 1226177 (N.D. Tex. Mar. 25, 2014).

[275] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 1226177, at *4 (N.D. Tex. Mar. 25, 2014).

[276] *Id.* at *6.

[277] *United States v. Whisenhunt*, No. 3:12-CV-0614-B, 2014 WL 3610792, at *6 (N.D. Tex. July 21, 2014).

[278] I.R.C. § 6324(a)(s); Treas. Reg. § 301.6324-1(a)(1).

[279] *See* 771 F.3d 854, 859 (5th Cir. 2014). Although *Marshall* involved gift tax liability under § 6324(b) rather than estate tax liability under § 6324(a), the gift and estate tax provisions in this statute are *in pari materia* and should be construed together. *See id.* at 864 n.5.

[280] *Id.* at 860.

[281] *Id.*

[282] *Id.*

dissent explaining that the plain language of § 6324 unambiguously limits a transferee's personal liability for unpaid gift or estate tax, including interest, to the value of the asset,[283] the Fifth Circuit affirmed, holding that accrued interest on a donee's liability for the unpaid taxes under § 6324 is not limited to the value of the gift.[284] Since there is a split among the circuits regarding this issue, it will be interesting to see how it is ultimately resolved.

XI. CONCLUSION

"An ounce of prevention is worth a pound of cure."
~ Benjamin Franklin

No doubt about it, preparing an estate tax return can be a complex and arduous task. Getting an early start is important in order to determine whether an estate tax return will be required and how much estate tax liability is likely to be due. Concurrently with obtaining information and documents to help with those determinations, the practitioner can get other required items moving down the pipeline. In the event that Form 706 will indeed be filed, thorough preparation is the key to successfully completing a solid estate tax return that can withstand IRS scrutiny. It is the author's hope that this article is a helpful tool that practitioners can use to prepare for many of the issues that can crop up when dealing with the federal estate tax.

[283] *Id.* at 878-83.
[284] *Id.* at 862.

PLANNING FOR NEW BASIS AT DEATH

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PLANNING FOR NEW BASIS AT DEATH

I. INTRODUCTION

Historically large federal gift and estate tax exemptions plus the availability of portability mean that for many taxpayers, estate and gift taxes are simply no longer a primary concern. At the same time, increased applicable income tax rates have brought a new focus on the importance of income tax planning. The combined effect of these changes has given rise to a new emphasis on maximizing a taxpayer's basis in property acquired from a decedent.

II. THE NEW TAX ENVIRONMENT

A. ATRA Changes to Rates and Exemptions

The American Taxpayer Relief Act of 2012 ("ATRA") was passed by Congress on January 2, 2013 and signed into law on January 4, 2013. As a result, we now have "permanent," unified estate, gift, and generation-skipping transfer tax legislation with some little twists. ATRA adjusted tax rates and made the changes to the gift, estate and GST tax exemptions first enacted in 2010 "permanent," while increasing the effective federal estate tax rate on the excess from 35% to 40%. As a result, we now have permanent unified estate, gift and GST tax laws with an exemption of $5,000,000, adjusted annually for inflation after 2010, and a top estate, gift and GST tax bracket of 40%. For 2014, after applying the inflation adjustment, the exemption is $5,340,000. Easy to remember for the dyslexic among us, the 2015 exemption is projected to be $5,430,00. At the same time, federal income tax rates were increased, for individuals, trusts and estates to 39.6% for ordinary income and 20% for qualified dividends and capital gain tax.

B. The Net Investment Income Tax

Coincidentally, although not a part of ATRA, January 1, 2013 also ushered in an entirely new 3.8% income tax. The Health Care and Education Reconciliation Act of 2010 ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. For individuals, the tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For individuals who are married filing jointly, the threshold is $250,000; for married filing separately, $125,000 each; and for single individuals, $200,000. For estates and trusts, the 3.8% tax applies to the lesser of *undistributed* net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts, which was $11,950 for 2013, $12,150 for 2014 and will be $12,300 for 2015. When combined with the increase in income tax rates noted above, the additional 3.8% tax on net investment income yields a top tax rate of 43.4% on ordinary income and a top tax rate of 23.8% on capital gains and qualified dividends.

C. Portability

The Tax Reform Act of 2010 added, and ATRA made permanent, the notion of "portability" of a deceased spouse's unused exemption amount. In essence, portability provides that upon the death of one spouse, the executor of that spouse's estate may file an estate tax return and elect on that return to allow the surviving spouse to effectively inherit any unused federal estate tax exemption of the deceased spouse. In other words, the deceased spouse's unused exemption amount can be "ported" to the surviving spouse. IRC § 2010(c)(2)(B). The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE Amount." Once a spouse inherits a DSUE Amount, the surviving spouse can use the DSUE Amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE Amount from his or her "last deceased spouse." A simple example illustrates this concept.

Example 1: H dies in 2011 with an estate of $3 million. He leaves $2 million outright to his wife W, and the balance to his children. As a result, his taxable estate is $1 million ($3 million, less a $2 million marital deduction). The executor of H's estate elects to file an estate tax return using $1 million of H's $5 million estate tax exemption[1] to shelter the gift to the children, and pass (or "port") the other $4 million of H's estate tax exemption to W. W would then have an estate and gift tax exemption of $9 million (her own $5 million exemption plus H's unused $4 million exemption).

As a result, married couples can effectively shelter up to $10.86 million (using 2015 figures) in wealth from

[1] Although the surviving spouse's exemption amount would be adjusted each year for inflation, the $4 million DSUE amount would not. Unless stated otherwise, this outline assumes a $5 million exemption without adjustment for illustration purposes, to make the math easier.

federal gift or estate tax without utilizing any sophisticated estate planning techniques.

III. WHAT IS BASIS?

Basis is a fundamental concept in income tax planning. A taxpayer may recognize taxable income whenever he or she sells assets at a gain. Gain is measured by the excess of the amount realized from a disposition of property over the taxpayer's adjusted basis in that property. IRC § 1001. In general, a taxpayer's basis in an asset is measured by its cost, with certain adjustments. IRC §§ 1012, 1016. However, a special rule applies if the property in question is acquired from a decedent. IRC § 1014(a).

A. Basis in Property Acquired from a Decedent

With a few exceptions, the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passed from a decedent, is equal to: (i) the fair market value of the property at the date of the decedent's death; (ii) if an "alternate valuation date" election is validly made by the executor of the decedent's estate, its value at the applicable valuation date prescribed by Section 2032 of the Internal Revenue Code (the "Code"); and (iii) if a "special use valuation" election is validly made by the executor of the decedent's estate, its value for special use valuation purposes prescribed by Section 2032A of the Code. IRC § 1041(a). In short, then, in most cases, the basis in property inherited from a decedent is the value of that property for federal estate tax purposes. Although often called a "step-up" in basis, various assets may be stepped up *or down* as of the date of death. Therefore, it is more accurate to call it a basis adjustment. Original basis is simply ignored and federal estate tax values are substituted. The adjustment to the basis of a decedent's assets occurs regardless of whether an estate tax return is filed, and regardless of whether the estate is even large enough to be subject to federal estate tax.

B. What Property is "Acquired from a Decedent"?

Most people think of property "acquired from a decedent" as simply property passing to them under the Will of a deceased person. For purposes of fixing basis, however, the Code lists ten separate methods by which property can be acquired from a decedent. Some of the listed methods contain effective dates that have since past, which make parsing the statute somewhat difficult. In summary, the current list includes the following seven items:

1. Inherited Property. Property acquired by bequest, devise, or inheritance. The statute makes clear that the basis adjustment applies not only to beneficiaries, but also to the decedent's property held by his or her estate. IRC § 1014(b)(1).

2. Revocable Trust Property. Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust. IRC § 1014(b)(2).

3. Property with Retained Right to Control Beneficial Enjoyment. Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. IRC § 1014(b)(3).

4. Property Subject to a General Power of Appointment. Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by Will. IRC § 1014(b)(4).

5. Both Halves of Community Property. Property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate. Thus, unlike the surviving spouse's separate property, *both halves* of a couple's community property receive a new cost basis upon the death of either spouse. IRC § 1014(b)(6).

6. Other Property Includable in the Decedent's Gross Estate. Property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate for estate tax purposes. IRC § 1014(b)(9). Clearly, the provision applying a basis adjustment for property "included in determining the value of the decedent's gross estate" overlaps several other provisions. Revocable trust property, property with a retained right to control beneficial enjoyment, property passing pursuant to the exercise of a power of appointment, and QTIP property are all included in determining the value of the decedent's gross estate. But this catch-all provision of Section 1014(b)(9) alone is subject to a curious limitation. As discussed below, any basis adjustment allowed solely by reason of Section 1014(b)(9) is reduced by "the amount allowed to the taxpayer as deductions … for exhaustion, wear and tear, obsolescence, amortization and depletion on such property before the death of the decedent."

7. QTIP Property. Property includible in the gross estate of the decedent under Code Section 2044 (relating to property for which a "QTIP" marital deduction was previously allowed). IRC § 1014(b)(10).

C. Exceptions

Not all property acquired from a decedent receives a new cost basis at death.

1. Assets Representing Income in Respect of a Decedent. Most notably, items which constitute income in respect of a decedent ("IRD") under Code Section 691 do not receive a new cost basis. Generally, IRD is comprised of items that would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and income tax reporting method, are not reportable as income on the decedent's final income tax return. Examples of IRD include accrued interest, dividends declared but not payable, unrecognized gain on installment obligations, bonuses and other compensation or commissions paid or payable following the decedent's death, and amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Comm'r*, 667 F.2d 675 (8th Cir. 1981): (i) the decedent must have entered into a "legally significant transaction"—not just an expectancy; (ii) the decedent must have performed the substantive tasks required of him or her as a precondition to the transaction; (iii) there must not exist any economically material contingencies which might disrupt the transaction; and (iv) the decedent would have received the income resulting from the transaction if he or she had lived. The basis in an IRD asset is equal to its basis in the hands of the decedent. IRC § 1014(c). This rule is necessary to prevent recipients of income in respect of a decedent from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his or her basis in the asset (such as gain being reported on the installment basis).

2. Property Inherited within One Year of Gift. A special exception is provided for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor or the donor's spouse as a result of the decedent's death. IRC § 1014(e). This rule is designed to prevent taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

3. Depreciable Property Owned by Others. As noted above, if a basis adjustment arises solely from the application of Section 1014(b)(9), the basis adjustment is reduced by the amount allowed "to the taxpayer" for depreciation, amortization or depletion prior to the decedent's death. IRC § 1014(b)(9). This limitation apparently applies only where someone other than the decedent owns depreciable, amortizable or depletable property which is nevertheless includible in the decedent's taxable estate. It appears to have originated at a time when assets given away within three years of death were taxed to the decedent under a prior version of Code Section 2035. *See* Treas. Reg. § 1.1046-6(a)(3) Ex. 1. Its application is not, however, limited to that situation. Thus, for example, the provision has been applied to depreciated property transferred subject to a retained life estate. *See* Treas. Reg. § 1.1046-6(a)(1). It has also been applied to property held as joint tenants with rights of survivorship. Rev. Rul. 58-130, 1958-1CB 121. If an owner of the property was able to claim a deduction for depreciation, amortization or depletion during the decedent's lifetime, this provision prevents the owner from recouping that deduction as a result of having the property included in another person's estate. Thus, for example, assume that A made a gift of depreciable property with a basis of $50,000 to B, and retained a life estate. Prior to A's death, B claimed depreciation deductions of $20,000. When A dies, the property, valued at $80,000, is included in determining the value of A's gross estate under Section 2036(a)(1). Pursuant to Section 1014(b)(9), B's adjusted basis of the property as of the date of the decedent's death is $60,000 ($80,000, the fair market value at the decedent's death, less $20,000, the total depreciation deduction actually allowed to B). *See* Treas. Reg. § 1.1014-6(a)-(c).

4. Property Subject to a Conservation Easement. Property that is the subject of a conservation easement is entitled to special treatment for estate tax purposes. In general, if the executor so elects, the value of certain conservation easement property may be excluded from the value of the decedent's estate under Code Section 2031(c), subject to certain limitations. To the extent of the exclusion, the property retains its basis in the hands of the decedent. IRC § 1014(a)(4).

D. Contrast Basis in Property Acquired by Gift

Unlike property acquired from a decedent, property acquired by gift (whether the gift is made outright or in trust), generally receives a "carry-over" basis. But, unrecognized losses incurred by the donor do not carry over to the donee. Solely for determining a donee's loss on a sale, the donee's basis cannot exceed the fair market value of the property at the date of the gift. IRC § 1015(a). In other words, if the donor's basis in an asset exceeds its fair market value at the date of the gift, the donee's basis may be one number for purposes of determining gain on a later sale, and another for purposes of determining loss. In either event, the amount of the donee's basis is increased (but not beyond the fair market value of the property) by the amount of any gift tax paid by the donor on the transfer. IRC § 1015(d).

1. Donee's Basis to Determine Gain. For purposes of determining gain (and for purposes of determining depreciation, depletion, or amortization), the basis of property acquired by gift is the same as it would be in the hands of the donor or, in the case of successive gifts, of the last preceding owner by whom it was not acquired by gift. IRC § 1015(a).

2. Donee's Basis to Determine Loss. For purposes of determining a loss on sale, if the fair market value of the property at the time of the gift was less than the donor's adjusted basis, the basis for determining loss is the fair market value as of the time of the gift. *Id*. Fair market value for this purpose is determined in the same manner as it is for purposes of determining the value of the property for gift tax purposes. Treas. Reg. § 1.1015-1(e). The "lower of fair market value or basis" rule does not apply to transfers to a spouse, whether made incident to a divorce or otherwise. IRC § 1015(e). Instead, the basis of the transferee in the property is equal to the adjusted basis of the transferor for all purposes. IRC § 1041(b)(2).

Example 2: X gives stock to Y with a fair market value of $100 and an adjusted basis of $270. The following year, Y sells the stock for $90. Since Y is selling the stock at a loss, Y must use the lesser of X's basis or the stock's fair market value ($100) as the basis, and may recognize a loss of only $10. The $170 loss in value suffered by X is foregone. If instead, Y sold the asset for $150, a paradox arises. If Y were permitted to utilize X's basis of $270, Y would incur a $120 loss on the sale. However, Section 1015 of the Code provides that if a loss would otherwise arise, Y's basis is the lesser of X's basis or the stock's fair market value ($100). But Y's basis cannot be the fair market value on the date of the gift ($100), because fair market value is used as the donee's basis only when a loss would be recognized, and no loss would be recognized if there were a $100 basis in the stock. Therefore, Y recognizes neither a gain nor a loss.

3. The Cost of Foregoing Basis. One of the main transfer-tax advantages of making a gift is that any post-gift appreciation is not subject to estate tax. But, as noted above, one cost of lifetime gifting is that there will be no basis adjustment for the gifted asset at death. As a result, the asset may need to appreciate significantly after the gift in order for the 40% estate tax savings on the appreciation to offset the loss of basis adjustment for the asset. For example, assume a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step-up in basis. At a 23.8% effective capital gain rate (if the family members are in the top tax bracket), this means the family will receive a net value of $762,000 from the asset after it is sold. If the donor had retained the asset until death, and if the property does not appreciate, the transfer tax implications would be the same (since the adjusted taxable gift rules under Code Section 2001(b)(1)(B) effective use up an equivalent exemption at death). But if the asset were held at death, the basis adjustment would save $238,000 of capital gain taxes. In order for the estate tax savings on post-gift appreciation to offset the loss of basis adjustment, the asset would have to appreciate from $1,000,000 to $2,469,136 (nearly 147%) (appreciation of $1,469,135 x .40 estate tax rate = gain of $2,469,135 x .238 capital gain rate).[2] Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with like-kind exchanges, basis step-up is not as important.

IV. Do Our Old Planning Tools Still Work?

Traditionally, estate planners have recommended that their clients incorporate a variety of techniques into their estate plans which were designed to avoid, defer, or

[2] *See* Carlyn McCaffrey, "Tax Tuning the Estate Plan by Formula," 33 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 4, ¶ 403.5 (1999). Mahon, "The 'TEA' Factor," TR. & ESTS. (Aug. 2011).

minimize the estate tax payable when property passed from one taxpayer to another. These strategies have often involved the use of one or more trusts which were aimed at minimizing transfer taxes. A corollary effect of many of these techniques was that income taxes payable might be increased in some cases, but with estate and gift tax rates exceeding 50%, and capital gain rates at only 15%, the income tax "cost" associated with many common estate planning tools seemed worthwhile. Under the current tax regime, higher estate tax exemptions and the availability of portability mean that many clients are no longer subject to estate or gift taxes, regardless of whether the estate planning strategies recommended in the past are employed. At the same time, the income tax cost of these strategies has increased, due to the enactment of higher federal income tax rates and the adoption of the 3.8% tax on net investment income.

A. Using Bypass Trusts.

1. Basis Adjustment at Second Death. For years, estate planners have designed bypass trusts with the express goal of excluding those assets from the taxable estate of the surviving spouse for estate tax purposes. While estate taxes were avoided, so too was a cost basis adjustment in those assets upon the death of the surviving spouse.

Example 3: H and W have a community property estate of $6 million (or simply two relatively equal estates totaling $6 million). H dies with a Will that creates a traditional bypass trust for W. W outlives H by 10 years. Over that time, the trustee distributes all of the bypass trust's income to W, but the fair market value of the trust's assets has doubled to $6 million. Meanwhile, W has retained her own $3 million in assets, which have held their value at $3 million. At the time of W's death, no estate will be due on her $3 million estate. The assets in the bypass trust will not be included in her estate for federal estate tax purposes, so they will not receive a new cost basis at the time of her death. As a result, their children will inherit assets in the bypass trust with a value of $6 million, but with a basis of only $3. If instead, H had left the property outright to W, and if H's executor had filed an estate tax return electing portability, no estate tax would be owed on W's $9 million estate. Had H left his assets to W outright (or to a differently designed trust), the children would have received a new cost basis of $6 million in the assets passing from H to W, potentially saving them $714,000 in taxes ($3,000,000 x 23.6%).[3]

2. Higher Ongoing Income Tax Rates. Single individuals are subject to the highest income tax rates on income in excess of $400,000 ($413,200 in 2015), and are subject to the tax on net investment income if their income exceeds $200,000. IRC §§ 1, 1411. In contrast, income not distributed from a trust is taxed at the top income tax rate to the extent it exceeds $12,300 (for 2015), and is subject to the net investment income tax if its undistributed net investment income exceeds that amount *Id.* Therefore, under the foregoing example, unless the wife's taxable income would otherwise exceed $413,200 ($464,850 if she remarries and files jointly) any taxable income accumulated in the bypass trust will be taxed at a higher income tax rate than it would if no trust had been used. Including the tax on undistributed net investment income, the trust's tax rate might be 43.4% for short term capital gains and ordinary income and 23.8% for long term capital gains and qualified dividends. Contrast these rates to rates of only 28% for ordinary income and 15% for capital gains if the wife remained single and her taxable income were between $90,750 and $189,300 (or between $129,600 and $200,000 if she remarried—all using 2015 income tax brackets). IRC § 1.

3. Some Assets Cause Greater Tax Burdens. A client's asset mix may impact the importance of these issues. For example, assets such as IRAs, qualified plans, and deferred compensation may give rise to ordinary income taxes without regard to their basis. Retirement plan assets left outright to a spouse are eligible to be rolled over into the spouse's name, which may make them eligible for a more favorable income tax deferral schedule than if they passed into a bypass or other trust. A personal residence may be eligible to have all or a portion of any capital gains tax recognized on its sale excluded from income if owned outright. IRC § 121(a). The exclusion is not available to the extent that the residence is owned by a non-grantor trust. *See* TAM 200104005. Some types of business entities (notably, S corporations) require special provisions in the trust to ensure that they are eligible to be treated as "Qualified Subchapter S Trusts" or "Electing Small Business Trusts." If these provisions are omitted or overlooked during the administration of the trust,

[3] Of course, an outright bequest would have a much worse tax result if the wife had remarried and her second husband had died leaving her no DSUE amount, or if H's property had declined in value, thereby causing a step-down in basis.

substantially higher taxes may result to all shareholders of the entity.[4]

Example 4: H has an IRA worth $1 million which earns 6% per year, the beneficiary of which is the trustee of a bypass trust for W. H dies when W is 60 years old. Because the IRA is payable to the trust, W cannot role the IRA over into her own IRA. Instead, she must begin to take minimum required distributions in the year following H's death, based upon her single life expectancy. If instead, the IRA had been payable to W, she could have rolled the IRA over to her own IRA, deferred minimum required distributions until age 70 ½, and used the more favorable unified table for her life expectancy. If W lives to age 90 taking only minimum required distributions, then in either event, W would receive about $1.4 million after tax from the IRA. Since the IRA was payable to the bypass trust, it would then hold about $2.75 million. If instead, the IRA had been payable to W, the ability to defer distributions for an additional 10 years would mean that the IRA would hold nearly $4 million!

4. Disclaimer Bypass Trusts. With proper advanced drafting, married couples can structure their Wills or revocable trusts to allow the surviving spouse to take a "second look" at their financial and tax picture when the first spouse passes away. If the total combined estates will be less than the applicable exclusion amount (including any DSUE amount) then the survivor can accept an outright bequest of assets, and if desired, the executor can file an estate tax return making the DSUE election. If the total value of the estate is expected to exceed the applicable exclusion amount, then the surviving spouse can disclaim all or any part of the inheritance. Language in the Will or revocable trust could provide that the disclaimed amount passes into the bypass trust. In order for the disclaimer to be effective, it must comply with the technical requirements of local law and the Internal Revenue Code. *See, e.g.*, TEX. ESTS. CODE Chpt. 122; IRC § 2518. The disclaimer must be filed within nine months of the date of death *and* before any benefits of the disclaimed property are accepted. The disclaimed property must generally pass in a manner so that the disclaiming party will not benefit from the property. An important exception to this rule, however, permits the surviving spouse to disclaim property and still be a beneficiary of a trust, including a bypass trust, to which the disclaimed property passes. IRC § 2518(b)(4)(A). More troubling is the requirement that the disclaimed property must pass without direction or control of the disclaiming party. This requirement generally prevents (or at least greatly restricts) the surviving spouse from retaining a testamentary power of appointment over the bypass trust to which assets pass by disclaimer. *See* Treas. Reg. § 25.2518-2(e)(1)(i); Treas. Reg. § 25.2518-2(e)(5), Exs. (4)-(5).

B. Advantages of Trusts over Outright Bequests. With the advent of "permanent" high estate tax exemptions and portability, estate planners and their clients concerned about the foregoing issues, or simply seeking "simplicity," may conclude that using trusts in estate planning is no longer warranted. But tax issues are only one part of the equation. In many respects, outright bequests are not nearly as advantageous as bequests made to a trust. In an ideal world, the estate plan would be designed to capture all of the benefits of trusts, without the tax downsides. Why might someone choose to make a bequest in trust, despite the potential tax costs, instead of outright? There are a number of reasons.

1. Control of Assets. A trust allows the grantor to be sure that the assets are managed and distributed in accordance with his or her wishes. Many clients express confidence that their spouses will not disinherit their family, but they still fear that a second spouse, an unscrupulous caregiver, or other unforeseen person or event may influence the surviving spouse to change the estate plan in ways that they do not intend. Placing property into trust allows the grantor to control to some extent how much (if at all) the surviving spouse can alter the estate plan.

2. Creditor Protection. If an inheritance passes outright and free of trust, the property will be subject to attachment by outside creditors unless the property is otherwise exempt from attachment under local law (in Texas, for example, these assets would include a homestead or an interest in a retirement plan). Assets inherited in trust are generally all protected from creditors so long as the trust includes a valid "spendthrift" clause. *See, e.g.*, TEX. PROP. CODE § 112.035.

3. Divorce Protection. Inherited assets constitute separate property of the recipient, which provides some measure of divorce protection. *See, e.g.*,TEX. FAM. CODE § 7.002. However, in Texas, if those assets are

[4] *See* Davis, *Income Tax Consequences (and Fiduciary Implications) of Trusts and Estates Holding Interests in Pass-Through Entities*, State Bar of Texas 25th Ann. Adv. Est. Pl. & Prob. Course (2001).

commingled, the community property presumption may subject them to the claims of a spouse upon divorce. *See* TEX. FAM. CODE § 3.003. Similar laws regarding marital property may apply even in non-community property states. If the assets pass in trust, however, the trustee's ownership of the trust assets helps ensure that they will not be commingled. In addition, the same spendthrift provisions that protect trust assets from other creditors protects them from claims of a prior spouse, although spendthrift provisions do not prevent trust assets from being used to pay child support claims. TEX. FAM. CODE § 154.005.

4. Protection of Governmental Benefits. If the surviving spouse is eligible (or may become eligible) for needs-based government benefits (e.g. Medicaid), a bypass or other trust may be structured to accommodate eligibility planning. An outright bequest to the spouse may prevent the spouse from claiming those benefits.

5. Protection from State Inheritance Taxes. Assets left outright may be included in the beneficiary's taxable estate for purposes of state estate or inheritance tax. While the inheritance tax in many states has been repealed or is inoperable so long as there is no federal estate tax credit for state death taxes paid, there can be no assurance that the beneficiary will reside (or remain) in one of those states. Currently, 19 states and the District of Columbia impose a separate stand-alone estate or inheritance tax.[5] The potential exposure depends upon the exemptions and rates applicable at the time of the beneficiary's death, but the applicable taxes can be surprisingly high. (*See, e.g.,* Washington State's RCW 83.100.040 (2013) imposing a 20% state estate tax on estates exceeding $2 million in value).

6. Income Shifting. If permitted, income earned by a trust can be distributed to trust beneficiaries, who may be in lower income tax brackets than the surviving spouse or the trust. IRC §§ 651, 661. Income from assets left outright cannot be "sprinkled" or "sprayed" to beneficiaries in lower tax brackets. For many families, a trust's ability to shift income may lower the overall family income tax bill.

7. Shifting Wealth to Other Family Members. While a surviving spouse might make gifts of his or her assets to children, elderly parents, or other family members, those gifts use up the spouse's gift and estate tax exemption to the extent that they exceed the gift tax annual exclusion. If assets are held in a bypass trust, and if the trust permits distributions to other family members, the amounts distributed to them are not treated as gifts by the surviving spouse, and do not use the spouse's gift or estate tax exemption or annual exclusion, regardless of their amount.

8. No Inflation Adjustment. The DSUE amount, once set, is not indexed for inflation, whereas the surviving spouse's basic exclusion amount (the $5 million) is adjusted beginning in 2012 for inflation after 2010 ($5.34 million in 2014 and $5.43 million in 2015). In addition, if assets are inherited in a bypass trust, any increase in the value of those assets remains outside the surviving spouse's estate. The importance of this feature increases: (i) as the value of a couple's net worth approaches $10 million; (ii) if asset values are expected to increase rapidly; and (iii) if the surviving spouse may be expected to outlive the decedent by many years.

Example 5: H dies in 2011 with a $4 million estate. His Will leaves everything to W, and a portability election is made. W has her own estate, also worth $4 million. During the next nine years, the estate grows at 6% per year, while inflation is only 3% per year. W dies at the end of 9 years. At that time, her estate (plus the amount she inherited from H) has grown to about $13.5 million, while her basic exclusion has grown to only about $6.5 million. When combined with the $5 million DSUE amount received from H, her applicable exemption amount is $11.5 million, resulting in federal estate taxes of about $800,000. If instead, H's $4 million estate had passed into a bypass trust for W, W's basic exclusion of $6.5 million plus her DSUE amount of $1 million would exceed her $6.75 million estate. Instead of paying $800,000 in estate tax, no estate tax would be due on her estate, and no estate tax would be paid on the $6.75 million owned by the bypass trust.

9. Risk of Loss of DSUE Amount. The surviving spouse is entitled to use the unused estate tax exemption only of the most recently deceased spouse. IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, the new spouse (who may have a substantial estate, or for whose estate an estate tax return may not be filed to pass along any DSUE amount), becomes the last deceased spouse. Unless the

[5] The states that impose an estate or inheritance tax at death are Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont and Washington. See Adirenne M. Penta, *Rest in (Tax-Free) Pease*, 153 TRUSTS & ESTS. 45 (2014).

surviving spouse makes taxable gifts before the new spouse's death (thereby using the DSUE amount of the first deceased spouse), any unused exemption of the first spouse to die is then lost. If no DSUE amount is acquired from the new last deceased spouse, the cost to the family could be $2.1 million or more in additional estate tax (40% of $5.34 million). This risk does not apply if assets are inherited in a bypass trust.

Example 6: W1 dies in 2011, leaving her entire estate to H, and a portability election is made with regard to W1's estate on a timely filed estate tax return. H marries W2 in 2014. W2 dies in 2015 leaving her sizable estate to the children of her first marriage. As a result, no DSUE amount is available to H with regard to W2's estate. Since W2 is now H's "last deceased spouse," H has no DSUE amount. The DSUE amount formerly available from W1 is lost.

10. No DSUE Amount for GST Tax Purposes. There is no "portability" of the GST tax exemption. In 2014, a couple using a bypass trust can exempt $10.68 million or more from both estate and GST tax, if not forever then at least a long as the Rule Against Perpetuities allows. A couple relying only on portability can only utilize the GST tax exemption of the surviving spouse ($5.34 million in 2014).

Example 7: Assume the same facts as in the Example 5. If portability is used, only $12.7 million after tax ($13.5 million less $800,000 in tax) is left to pass to trusts for children. W may shelter only $6.5 million of that amount from GST tax, since only her (inflation-adjusted) GST tax exemption is available to allocate to the children's trusts. The balance ($6.2 million) will not be exempt from GST tax, and will likely be taxed in the estate of the children. If instead, H's estate had passed into a bypass trust, H's GST exemption could have been allocated to the bypass trust, and the exemption would have continued on in trusts for children. In addition, W could allocate her GST tax exemption to shelter almost all of her $6.75 million after-tax estate. Not only would the children inherit $800,000 more, but virtually all of the inheritance could pass to them in GST tax-exempt trusts.

Efficient use of a couple's GST tax exemption may be more important if the couple has fewer children among whom to divide the estate, especially when those children are successful in their own right.

Example 8: H and W, a married couple with a $10 million estate, leave everything outright to their only child C. As a result, C immediately has a taxable estate. If instead, after leaving everything to each other (using portability), the survivor leaves assets to a lifetime trust for C, only about half of the estate can pass into a GST tax-exempt trust, using the surviving spouse's GST tax exemption. The balance will pass into a non-exempt trust for C (usually with a general power of appointment), which can lead to an additional $5 million (plus growth) added to C's estate. If the first spouse's estate had passed into a bypass trust (or, as discussed below, into a QTIP trust for which a "reverse" QTIP election was made for GST tax purposes), the entire $10 million could pass into a GST tax-exempt trust for C, completely avoiding estate tax at the time of C's death.

11. Must File Estate Tax Return For Portability. In order to take advantage of the DSUE amount, the executor of the deceased spouse's estate must file a timely and complete estate tax return. Once the last estate tax return is filed, any election regarding portability is irrevocable. If there is no appointed executor, the regulations provide that persons in possession of the decedent's assets (whether one or more) are the "executor" for this purpose. If those persons cannot agree upon whether to make the portability election, a probate proceeding may be advisable, simply to appoint an executor.

C. Using QTIPable Trusts. Placing property into a trust eligible for the estate tax marital deduction offers many of the same non-tax benefits as bypass trusts but without many of the tax detriments.

1. Control, Creditor and Divorce Protections. Like a bypass trust, a QTIP trust offers creditor and divorce protection for the surviving spouse, potential management assistance through the use of a trustee or co-trustee other than the spouse, and control over the ultimate disposition of assets for the transferor.

2. Less Income Tax Exposure. To be eligible for QTIP treatment, QTIP trusts must distribute all income at least annually to the surviving spouse. IRC § 2056(b)(7)(B). While QTIP trusts are subject to the same compressed income tax brackets as bypass trusts, since all fiduciary income must be distributed, less taxable income is likely to be accumulated in QTIP trusts at those rates. Keep in mind that the requirement that a QTIP trust must distribute all of its income means only that its income measured under state law and the governing instrument need be distributed to the surviving spouse. IRC § 643(b). In measuring fiduciary accounting income, the governing instrument and local law, not the Internal Revenue Code, control.

Nevertheless, the "simple trust" mandate that a QTIP trust distribute all of its income at least annually will typically mean that less taxable income is subjected to tax in a QTIP trust than in a bypass trust.

3. New Cost Basis at Second Spouse's Death. If a QTIP election is made under Section 2056(b)(7)(v) of the Code, then upon the death of the surviving spouse, the assets in the QTIP trust are treated for basis purposes as though they passed from the surviving spouse at the second death. IRC § 1014(b)(10). As a result, they are eligible for a basis adjustment at the death of the surviving spouse.

4. Preservation of GST Tax Exemption. If no QTIP election is made for the trust by filing an estate tax return, the first spouse to die is treated as the transferor for GST tax purposes, so GST tax exemption may be allocated (or may be deemed allocated), thereby preserving the GST tax exemption of that spouse. *See* IRC § 2632(e)(1)(B). If a QTIP election *is* made for the trust, the executor may nevertheless make a "reverse" QTIP election for GST tax purposes, again utilizing the decedent's GST tax exemption to shelter the QTIP assets from tax in succeeding generations. *See* IRC § 2652(a)(3).

5. QTIPs and Portability. From an estate tax standpoint, making the QTIP election means that the assets passing to the QTIP trust will be deductible from the taxable estate of the first spouse, thereby increasing the DSUE amount available to pass to the surviving spouse. IRC § 20256(b)(7). (*But see* the discussion of Revenue Procedure 2001-38 at page 10 below.) Of course, the assets on hand in the QTIP trust at the time of the surviving spouse's death will be subject to estate tax at that time as though they were part of the surviving spouse's estate. IRC § 2044. But if the surviving spouse's estate plus the QTIP assets are less than the surviving spouse's basic exclusion amount (or if a portability election has been made, less than the surviving spouse's applicable exclusion amount) then no estate tax will be due.

6. QTIPs and Using the DSUE Amount. One strategy that a surviving spouse might consider, especially if remarriage is a possibility, is to make a taxable gift prior to remarriage (or at least prior to the death of a new spouse) to be sure to capture the DSUE amount of the prior spouse. If the spouse is a beneficiary of a QTIP trust, one possible form of that gift would be to intentionally trigger a gift of the QTIP trust assets under Section 2519 of the Code. Section 2519 provides that if a surviving spouse releases any interest in a QTIP trust, transfer taxes are assessed as though the entire QTIP trust (other than the income interest) had been transferred. If the surviving spouse were to release a very small interest in the QTIP trust, the result would effectively be to make a gift of the entire QTIP, thereby using DSUE amount, even though the surviving spouse would retain the use of the unreleased income interest. By making a gift of the QTIP trust while retaining the income interest, the trust assets will be included in the surviving spouse's estate at death, thereby receiving a new cost basis. IRC § 1014(b)(4). Moreover, because estate tax inclusion arises under Code Section 2036 and not Section 2044, a corresponding adjustment will be made to the surviving spouse's computation of adjusted taxable gifts at death. *See* Treas. Reg. § 20.2044-1, Ex. 5.[6]

Example 9: W has a $5 million estate. W dies with a Will leaving all to a QTIP trust for H. W's executor files an estate tax return making both the QTIP and the portability elections. Immediately thereafter, H releases 0.5% of the income interest in the QTIP trust assets. The release of the income interest is a taxable gift of the 0.5% interest under Section 2511 of the Code, but more importantly, the release also constitutes a gift of the balance of the trust assets under Code Section 2519. Because the interest retained by H is not a qualified annuity interest, Code Section 2702 precludes any discounts on valuing that interest. The effect is for H to have made a $5 million gift, all of which is sheltered by W's DSUE amount. Even though the DSUE amount has been used, H still retains 99.5% of the income from the QTIP trust for life. In addition, the QTIP trust assets are included in H's estate under Code Section 2036, so a new cost basis will be determined for the assets when H dies. Because the assets are not included in the estate under Section 2044 of the Code, the taxable gift will not be treated as an adjusted taxable gift when H dies.

D. QTIP Trust Disadvantages. Even in the current tax regime, QTIP trusts pose some

[6] This technique is discussed in detail in Franklin and Karibjanian, *Portability and Second Marriages—Worth a Second Look*, 39 EST. GIFT & TRUST J. 179 (2014).

disadvantages when compared to bypass trusts. In particular:

1. No "Sprinkle" Power. Because the surviving spouse must be the sole beneficiary of the QTIP trust, the trustee may not make distributions from the QTIP trust to persons other than the surviving spouse during the surviving spouse's lifetime. IRC § 2056(b)(7)(B)(ii)(II). As a result, unlike the trustee of a bypass trust, the trustee of a QTIP trust cannot "sprinkle" trust income and principal among younger-generation family members. Of course, this places the surviving spouse in no worse position than if an outright bequest to the spouse had been made. The surviving spouse can still use his or her own property to make annual exclusion gifts to those persons (or after a portability election, make even larger taxable gifts without paying any gift tax by using his or her DSUE amount).

2. Estate Tax Exposure. Presumably, the QTIP trust has been used in order to achieve a step-up in basis in the inherited assets upon the death of the surviving spouse (which, of course, assumes that the trust assets appreciate in value—remember that the basis adjustment may increase or decrease basis). The basis adjustment is achieved by subjecting the assets to estate tax at the surviving spouse's death. The premise of using this technique is that the surviving spouse's basic exclusion amount (or applicable exclusion amount, if portability is elected) will be sufficient to offset any estate tax. There is a risk, however, that the "guess" made about this exposure may be wrong. Exposure may arise either from growth of the spouse's or QTIP trust's assets, or from a legislative reduction of the estate tax exemption, or both. If these events occur, use of the QTIP trust may expose the assets to estate tax. Again, this risk is no greater than if an outright bequest to the spouse had been used. However, if the source of the tax is appreciation in the value of the QTIP trust assets between the first and second death, and if the income tax savings from the basis adjustment is less than the estate taxes payable, then with hindsight, one could argue that using a bypass trust instead would have been more beneficial to the family.

3. Income Tax Exposure. A QTIP trust is a "simple" trust for federal income tax purposes, in that it must distribute all of its income at least annually. Remember, however, that simple trusts may nevertheless pay income taxes. As noted above, a trust which distributes all of its "income" must only distribute income as defined under the governing instrument and applicable state law, (typically, the Uniform Principal and Income Act), which is not necessarily all of its taxable income. Thus, for example, capital gains, which are taxable income, are typically treated as corpus under local law and thus not distributable as income. Other differences between the notions of taxable income and state law income may further trap taxable income in the trust. Although simple trusts often accumulate less taxable income than complex trusts, they may nevertheless be subject to income tax at compressed tax rates.

4. Is a QTIP Election Available? In Revenue Procedure 2001-38, 2001-1 CB 1335, the IRS announced that "[i]n the case of a QTIP election within the scope of this revenue procedure, the Service will disregard the election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The Revenue Procedure provides that to be within its scope, "the *taxpayer must produce sufficient evidence*" that "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." *Id.* (emphasis added). The typical situation in which the Revenue Procedure applies is the case where the taxable estate would have been less than the applicable exclusion amount, but the executor listed some or all of the trust property on Schedule M of the estate tax return and thus made an inadvertent and superfluous QTIP election.

An executor must file an estate tax return to elect portability, even if the return is not otherwise required to be filed for estate tax purposes. In that case, a QTIP election is not required to reduce the federal estate tax, because there will be no estate tax in any event. However, a QTIP election might still be made to maximize the DSUE amount, gain a second basis adjustment at the death of the surviving spouse, and support a reverse-QTIP election for GST tax purposes. Does Revenue Procedure 2001-38 mean that the IRS might determine that a QTIP election made on a portability return "was not necessary to reduce the estate tax liability to zero" and therefore treat the QTIP election as "null and void"?

Commentators have suggested that the Revenue Procedure is simply inapplicable if the surviving spouse or the surviving spouse's executor does not affirmatively invoke it. The Revenue Procedure itself, however, suggests that it may be invoked by "produc[ing] a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero." When a DSUE amount is utilized, the return on which portability was elected will need to be produced, and any return filed only to elect portability will necessarily show that the QTIP election was not necessary to reduce estate tax. Granted, to obtain relief, the Revenue Procedure also states that "an explanation of why the election should be treated as void" should be included with the return, suggesting that to be treated as void, the taxpayer needs to take affirmative action to request it.

It seems unlikely that a revenue procedure granting administrative relief can negate an election clearly authorized by statute. The regulations regarding portability make explicit reference to QTIP elections on returns filed to elect portability but not otherwise required for estate tax purposes. *See* Treas. Reg. § 20.2010-2T(a)(7)(ii)(A)(4). In the IRS's most recent Priority Guidance Plan, the IRS has indicated that it intends to issue a clear statement about the applicability of the Revenue Procedure in the context of portability. It seems likely that this guidance will authorize QTIP elections even for estates where no estate tax is otherwise due.

5. *Clayton* QTIP Trusts. When the statute authorizing QTIP trusts was first enacted, the IRS strictly construed language in Section 2056(b)(7) requiring the property in question to pass from the decedent. In *Clayton v. Comm'r*, 97 TC 327 (1991), the IRS asserted that no marital deduction was allowed if language in the Will made application of QTIP limitations contingent upon the executor making the QTIP election. The regulations also adopted this position. After the Tax Court found in favor of the IRS's position, the Fifth Circuit reversed and remanded, holding that language in a Will that directed property to a bypass trust to the extent no QTIP election was made did not jeopardize the estate tax marital deduction. *Clayton v. Comm'r*, 976 F2d 1486 (5th Cir. 1992). After other courts of appeal reached the same result and a majority of the Tax Court abandoned its position, the Commissioner issued new regulations that conform to the decided cases and permit a different disposition of the property if the QTIP election is not made. Treas. Reg. §§ 20.2056(b)-7(d)(3)(i), 20.2056(b)-7(h) (Ex. 6). The final regulations explicitly state that not only can the spouse's income interest be contingent on the election, but the property for which the election is not made can pass to a different beneficiary, a point that was somewhat unclear under the initial temporary and proposed regulations issued in response to the appellate court decisions. As a result, it is now clear that a Will can provide that if and to the extent that a QTIP election is made, property will pass to a QTIP trust, and to the extent the election is not made, the property will pass elsewhere (for example, to a bypass trust). Including this *Clayton* QTIP language in a client's Will would allow the executor of the estate of the first deceased spouse additional time compared to a disclaimer bypass trust to evaluate whether a QTIP or bypass trust is best. Because the QTIP election would need to be made on a federal estate tax return, the *Clayton* option would require the filing of an estate tax return if property is to pass to the QTIP trust. Presumably, since a QTIP election can be made on an estate tax return filed on extension, a *Clayton* QTIP would give the executor fifteen months after the date of death to evaluate the merits of the election. In addition, since no disclaimer is involved, there is no limitation on the surviving spouse holding a special testamentary power in the bypass trust that receives the property as a result of the *Clayton* election. Sample language invoking a *Clayton* QTIP trust is attached as Exhibit A.

If a *Clayton* QTIP election is contemplated, may the surviving spouse serve as the executor? There is a concern that the spouse's right to alter the form of her bequest from a bypass trust that may "sprinkle and spray" among family members to an "all income for life" QTIP trust might give rise to gift tax exposure to the spouse for making (or failing to make) the election. Most commentators agree that the safest course is for the spouse not to serve as executor. A somewhat more aggressive approach may be for the spouse to serve, but to require the surviving spouse/executor to make (or not make) the QTIP election as directed by a disinterested third party.

6. The QTIP Tax Apportionment Trap. Remember that if estate tax ultimately proves to be due as a result of having made the QTIP election, the source of payment for these taxes becomes important. Under federal law, except to the extent that the surviving spouse in his or her Will (or a revocable trust) specifically indicates an intent to waive any right of recovery, the marginal tax caused by inclusion of the QTIP assets in the surviving spouse's estate is recoverable from the assets of the QTIP trust. IRC § 2207A(1). Many state tax apportionment statutes adopt this rule, either expressly or by reference. *See, e.g.,* TEX. ESTS. CODE § 124.003. When the beneficiaries of the surviving spouse's estate and the remainder beneficiaries of the QTIP trust are the same persons, this rule generally makes little difference.

Where they differ, however, the result could be dramatic, and highlights the need to check the "boilerplate" of clients' Wills.

Example 10: H & W each have a $10 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder interest in the trust passing upon W's death to his children from a prior marriage. H's executor files an estate tax return making both the QTIP and the portability elections. W immediately thereafter, knowing she can live from the QTIP trust income, makes a gift of her entire $10 million estate to her children. No gift tax is due since W can apply her applicable exclusion amount (i.e., her basic exclusion amount plus H's DSUE amount of $5 million) to eliminate the tax. Upon W's later death, the remaining QTIP trust assets are subject to estate tax under Section 2044 of the Code. Since W used all of her applicable exclusion amount to shelter her gift to her children, none of her exemption (or a nominal amount because of the inflation adjustment of her basic exclusion amount) is available to shelter estate tax, and the entire $10 million (assuming no changes in value) is taxed. All of this tax is attributable to the QTIP trust assets, so unless W's Will expressly provides otherwise, the estate tax liability of $4 million is charged to the trust (and therefore, in effect, to H's children). As a result, H's children are left with $6 million from the remainder of the QTIP assets, while W's children receive $10 million tax free.

One solution to this problem may be to have H's executor agree to the portability election only if W (i) agrees to waive estate tax recovery under Section 2207A except to the extent of pro rata taxes (instead of marginal taxes); and (ii) agrees to retain sufficient assets to pay applicable estate taxes associated with her property transfers, whether during lifetime or at death. As one might imagine, drafting such an agreement would not be a trivial matter.

E. Is a "LEPA" Trust a Better Choice? A QTIP trust isn't the only method of obtaining a marital deduction for property passing into trust for a surviving spouse. Long before the advent of QTIP marital trusts, another form of marital trust was available. Unlike the more familiar QTIP trust format, this trust is available without the need to file an estate tax return.

1. Structure of LEPA Trusts. Section 2056(b)(5) of the Code permits a marital deduction for property passing into trust for a spouse so long as the surviving spouse is entitled for life to the income from all or a specific portion of the trust, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the trust property (exercisable in favor of the surviving spouse or the estate of the surviving spouse, or in favor of either, whether or not the power is exercisable in favor of others), so long as no power is given to anyone to appoint any part of the trust to anyone other than the surviving spouse. This so-called Life Estate Power of Appointment ("LEPA") trust thereby allows a marital deduction without many of the other restrictions applicable to QTIP trusts. Note that the spouse may be given the right to income from all of the trust (or a specific portion of the trust determined on a fractional or percentage basis) that is intended to qualify. The power of appointment must be exercisable by the spouse alone, and may be inter vivos or testamentary, as long as it is exercisable over all of the trust property from which the spouse has a right to the income. IRC § 2056(b)(5), (10).

2. Benefits of LEPA Trusts. Since the advent of QTIP trusts, estate planners have generally preferred them, since they allow the creator of the trust to restrict the disposition of any trust property remaining at the death of the surviving spouse, by restricting or even eliminating the surviving spouse's power to appoint the trust property. However, LEPA trusts do cause inclusion in the surviving spouse's estate, thereby providing a basis adjustment in the trust's assets at the death of the surviving spouse. IRC § 1014(b)(4). In addition, they provide many of the other trust benefits such as creditor protection and divorce protection, as well as management assistance through the use of a trustee or co-trustee other than the spouse. While neither the income nor the associated tax liability of a LEPA may be shifted to others, a LEPA may avoid application of compressed tax rates if the surviving spouse has a general power to appoint property to him- or herself during lifetime. IRC § 678. Especially in smaller estates of couples with children of the same marriage, and in states with no state estate tax, the LEPA trust may see a rise in popularity because couples with smaller estates don't need to file an estate tax return to get the second basis adjustment. The LEPA trust may also be preferred by estate planning advisors that fear that the IRS won't favorably resolve the risk to using QTIP trusts and portability posed by Revenue Procedure 2001-38, discussed above at page 10.

3. Disadvantages of LEPA Trusts. LEPA trusts do have some drawbacks. Most notably, while a QTIP trust permits preservation of the decedent's GST tax exemption by making a "reverse" QTIP election for GST tax purposes, there is no "reverse" LEPA election.

Assets in the trust are simply included as part of the surviving spouse's estate at the time of his or her death, and the surviving spouse is thereby treated as the transferor of the trust property for GST tax purposes. In addition, granting the surviving spouse a general testamentary power of appointment over trust assets may not be compatible with every client's estate plan. Also, the grant of a general power of appointment, whether inter vivos or testamentary, may subject the property to the spouse's creditors. This topic is discussed in more detail in section V.B.5 below at page 18.

V. A NEW ESTATE PLANNING PARADIGM

Marital trust planning, whether taking the form of QTIP trusts or LEPA trusts, can allow clients to obtain many of the income tax basis benefits of the outright/portability option, while at the same time achieving the estate preservation and asset protection planning advantages of a bypass trust. Thus, marital trusts can help solve the "loss-of-basis" disadvantages of bypass trusts discussed above, and can solve many of the disadvantages of outright planning. But is there an even better solution? Marital trusts, by causing trust property to be included in the surviving spouse's estate, actually achieve a full basis adjustment, which means that the assets in the trust receive not only a second step-up in basis if they appreciate, but also a second step-*down* in basis if their values decline. In addition, unlike bypass trusts, marital trusts cannot "sprinkle" income and assets to other beneficiaries. Moreover, they are somewhat "leaky," for both asset protection and income tax reasons, because of their mandatory income requirements.

A. Creative Options to Create Basis. Estate planners have suggested a number of other tools that could be brought to bear on the drawbacks presented by bypass trusts. Each of these options have advantages and disadvantages, and it appears that there may be no "one-size-fits-all" (or "even one-size-fits-most") solution to the problem.

1. Distribution of Low-Basis Assets. Perhaps the most straight-forward approach involves simply having the trustee of a bypass or other trust distribute to the surviving spouse low basis assets with a total value that, when added to the value of the surviving spouse's other assets, will cause his or her estate to be less than his or her available applicable exclusion amount. If the distribution can be justified as having been made for the spouse's health, education, maintenance or support (or however the trust's applicable distribution standard reads), then arguably, this distribution could be undertaken with no other special language in the governing instrument. So long as the spouse passes these assets at death to the same person(s) who would have received them from the trust, there is presumably no one to complain. The remaindermen receive the assets with a higher cost basis, so they are actually better off than if the distribution had never been made. This approach has its shortcomings. For example: (i) the trustee must identify the low-basis assets and distribute them to the spouse in the proper amount, presumably shortly before the spouse passes away; (ii) if the surviving spouse dies with substantial creditors or changes his or her dispositive plan before death, the remaindermen may be injured by the distribution (for which the trustee could presumably be liable if it can be shown that the distribution was not made pursuant to the applicable distribution standard); and (iii) if the surviving spouse truly has no need for the distribution, the IRS might argue that the distribution was unauthorized, asserting that a constructive trust or resulting trust was thereby imposed for the remainder beneficiaries, effectively excluding the assets from the spouse's estate (and precluding any step-up in basis). *See Stansbury v. U.S.,* 543 F Supp. 154, 50 AFTR 2d 82-6134 (ND Ill. 1982), aff'd 735 F2d 1367 (7th Cir. 1984) (holding, in an entirely different context, that assets subject to a constructive trust were excluded from the estate of the nominal owner for estate tax purposes); PLR 9338011 (holding that assets improperly distributed to a trust beneficiary would be deemed under local law to be held in a "resulting trust", and as a result, were not includable in the decedent's estate under IRC § 2033).

2. Granting Broad Distribution Authority. One option may be to designate an independent trustee (or co-trustee, or "distribution trustee") in a bypass trust, and to grant that person broad discretion to distribute up to the entire amount in the bypass trust to the surviving spouse. The theory would be that if the surviving spouse were nearing death with an estate valued below his or her applicable exclusion amount, the person holding this authority could simply distribute low-basis assets to the surviving spouse outright, thereby causing them to be included in the surviving spouse's estate, thus receiving a new cost basis at death. This authority could also be exercised more broadly if the family simply decided that the benefits of the bypass trust were not worth its costs (or not worth it as to certain assets), and the trustee/trust protector agreed to distribute the assets. Since the surviving spouse would not hold this authority, the assets remaining in the bypass trust would not be included in his or her estate. So long as the trustee/trust protector were not a remainder beneficiary of the trust, no gift would arise as a result of the exercise (or non-exercise) of the power. However, one would need to ensure that appropriate successors were named in case the first designated person failed or ceased to serve, and it would be prudent not to allow the surviving spouse or other beneficiaries of the trust to remove, replace, or fill a vacancy in the position by a person related to or subordinate to the trust beneficiaries under Code Section 672(c). *See* Rev. Rul. 95-58, 1995-2 CB 191.

Critics of this approach note that it is often impractical and requires considerable proactivity and perhaps even omniscience (not to mention potential liability) for the trustee/trust protector. Is it possible to find one person (let alone one or more back-ups) to fill this role? Can we expect the trustee/trust protector to know when the surviving spouse is likely to die, to know the cost basis of trust assets and to know an accurate net worth of the surviving spouse? Some posit that the duty could be drafted to arise only upon the request of the surviving spouse or one (or all) of the remainder beneficiaries. Even in that case, it seems likely that the trustee/trust protector may wish to hire counsel, to analyze the medical condition of the spouse, get signed waivers, and/or consult a distribution committee, time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill. And what happens if the spouse gets better? Finally, an outright distribution of property to the surviving spouse would subject the distributed property to the claims of the surviving spouse, which could in a worst-case scenario be the equivalent of a 100% "tax" on the distributed assets.

3. Giving a Third Party the Power to Grant a General Power of Appointment. A related technique advocates giving an independent trustee or trust protector not the distribution authority directly, but rather the power to grant to the surviving spouse (or others) a general testamentary power of appointment. The idea is that if it is apparent that no estate tax will be due upon the survivor's death, the power could be exercised to grant the spouse a general power, and thereby achieve a basis adjustment. This approach might protect the trust assets from creditors during the surviving spouse's lifetime, but it suffers from many of the same shortcomings as the technique just described. In particular, (i) it must have been included in the governing instrument; (ii) a person (or persons) willing and able to hold this power must be identified; (iii) the person must be willing to exercise the authority at the right time; and (iv) the surviving spouse might actually exercise the power and divert the assets outside the family. Any person given this authority must be concerned about being held liable by the trust's remaindermen for improvidently exercising (or failing to exercise) the power, or by the spouse if the power is exercised at a time when the spouse is expected to die but doesn't. More problematic is the concern that under Code Section 2041(b)(1)(C)(iii) a general power of appointment that is exercisable in conjunction with another person is nevertheless a general power if the other person does not have an adverse interest, and it is a general power as to the entire value of the trust property if the other person is not a permissible appointee. A trust protector would typically not have an adverse interest or be a permissible appointee. At least one commentator[7] has questioned whether there is any real difference between a power that is conferred by the protector and a power held jointly with the protector. If the IRS views them as the same, then the surviving spouse (in this example) would be deemed to hold a general power over *all of the trust assets* in all events, regardless of the size of the estate and *regardless of whether the protector exercised the authority to grant the power*.

4. Granting a Non-Fiduciary Power to Appoint to the Surviving Spouse. Some commentators have suggested that the fiduciary liability concerns associated with giving a trustee or trust protector broad distribution rights could be overcome by giving another party (typically a child, perhaps another family member, friend of the spouse or non-beneficiary), a non-fiduciary limited lifetime power to appoint property to the surviving spouse. A power of appointment granted in a non-fiduciary capacity may be exercised arbitrarily. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 (2011). Since the power would be granted with the express authority to exercise it (or not exercise it) in a non-fiduciary capacity, the power holder should be less concerned about exposure to claims of imprudence by trust beneficiaries. If the person holding the power is a beneficiary of the trust, its exercise may cause gift tax concerns. *See* Treas. Reg. §§ 25.2514-1(b)(2), -3(e), Ex. 3; PLR 8535020; PLR

[7] *See* Aucutt, *When is a Trust a Trust?* printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

9451049. If the person holding the power is not a beneficiary, however, the exercise or non-exercise of the power should have no tax implications to the power holder. But as noted with respect to distributions by an independent trustee or trust protector, appointing assets outright to the surviving spouse risks subjecting those assets to the spouse's creditors, and further exposes family members to the risk that the surviving spouse may disinherit them. In this regard, trust assets are a bit like toothpaste: once the assets are out of the trust "tube," you can't simply put them back in and have the same tax results.

5. Decanting the Bypass Trust to a Trust that Provides Basis. If the bypass trust does not by its terms contain provisions that would allow a basis adjustment at the death of the surviving spouse, some commentators have suggested that the trust be modified or decanted into a trust that has more favorable terms. While the intricacies of trust modifications and decanting are well beyond the scope of this paper, one need only note that this form of decanting may not be available in all jurisdictions. For example, under the current Texas decanting statute, no change may be made to the dispositive (as opposed to administrative) provisions of a trust via decanting unless the trustee's power to make distributions is not limited in any way. *See generally* TEX. PROP. CODE § 112.073 (stating the law governing distribution of property in a second trust when the trustee has limited discretion). It isn't merely a "health, education, maintenance and support" standard that causes a trustee's powers to be limited in Texas. Rather, literally any restriction on trustee powers imposes these limits. *See* TEX. PROP. CODE § 112.072(a). In addition, even if a trustee has unlimited discretion (a true rarity, and one which would seem to obviate the need to decant to achieve the aims discussed above), under current Texas law, no decanting may occur if it will "materially impair the rights of any beneficiary." TEX. PROP. CODE § 112.085(2). Decanting to a trust that grants a spouse broad powers of appointment might "materially impair" the rights of remainder beneficiaries. Finally, no matter the state involved, a trustee's power to decant is subject to the trustee's overall fiduciary duties, and may have tax consequences apart from achieving the basis aims discussed here. For a thorough discussion of decanting generally, s*ee* Willms, "Decanting Trusts: Irrevocable, Not Unchangeable," 6 EST. PLAN. & COMMUNITY PROP. L. J. 35 (2013).[8]

6. Making a Late QTIP Election. If the bypass trust happens to otherwise qualify as a QTIP trust, and no federal estate tax return was ever filed to not make a QTIP election, it may be possible to file an estate tax return to make a late QTIP election. Although somewhat rare, some bypass trusts qualify for QTIP treatment with a proper election. Specifically, the bypass trust must provide that the surviving spouse is the sole beneficiary during his or her lifetime, is entitled to demand or receive all net income at least annually, and can require unproductive property be made productive. Somewhat surprisingly, a QTIP election can be made on the last timely filed estate tax return, or, *if no return is filed on time, on the first late-filed return*. Treas. Reg. § 20.2056(b)-7(b)(4)(i). That means that long after the fact (conceivably, even after the death of the surviving spouse) a return could be filed that relates back to the time of the first spouse's death, thereby causing the trust assets to be included in the surviving spouse's estate and resulting in basis adjustment in the trust's assets at the second death. Note that it is unlikely that anything like surgical precision would be possible in this circumstance. Although partial QTIP elections are permitted, it is unlikely that the election could be made only as to those assets whose values increased between the first and second death. *See* Treas. Reg. § 20.2056(b)-7(b)(3).

B. The Optimal Basis Increase Trust ("OBIT"). In an ideal world, estate planners would design a trust that ensures that upon the surviving spouse's death, its assets get a step-up, but not a step-down in basis, doesn't generate any federal estate tax (or any extra state estate tax), achieves better ongoing income tax savings than a typical bypass or marital trust, and preserves asset protection benefits, all without the drawbacks described above. One approach to such a trust has been suggested by attorney Edwin P. Morrow, III who describes employing a combination of techniques with a bypass/marital trust plan to create what he refers to as an "Optimal Basis Increase Trust" or "OBIT."[9] The key feature of this plan is to make creative use of testamentary general and limited powers of appointment

[8] For a more recent version of this outline, *see* Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

[9] Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* printed as part of *Recipes for Income and Estate Planning in 2014*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

to (i) assure that assets in the trust receive a step-up in basis, but never a step-*down* in basis; and (ii) dynamically define or invoke these powers so as to not cause additional estate tax.

1. Granting a General Power of Appointment to Obtain Basis. As part of a traditional bypass trust, an OBIT might grant the surviving spouse a testamentary limited power of appointment (or no power at all) over all IRD assets (which cannot receive a new cost basis) and over assets with a basis higher than the fair market value at the time of the surviving spouse's death (for which no new basis is desired). However, it would grant the surviving spouse a general testamentary power of appointment ("GPOA") over any assets that have a fair market value greater than their tax basis.[10] Such a "split" power of appointment would assure that appreciated assets in the trust would receive a step-up in basis, but no assets would receive a step-down.

2. Applying a Formula to Avoid Estate Tax. What if the value of the appreciated assets in the bypass trust, when added to the value of the surviving spouse's estate, exceeds the surviving spouse applicable exclusion amount at the time of his or her death? In that event, basis would be acquired, but at the cost of paying estate tax. One alternative is to restrict the surviving spouse's GPOA by a formula. The formula would, in effect, provide that the GPOA is only applicable to appreciated trust assets to the extent it does not cause increased federal estate tax. (As a further refinement, the formula might also take into account state estate tax, if it is potentially applicable). Estate planners have been drafting formula powers of appointment for years (usually in the context of avoiding GST taxes) which limit the scope of the GPOA either as to appointees or assets. There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula. *See* Treas. Reg. § 20.2041-1(b)(3). In fact, one might further fine-tune the formula to limit its application first to those assets with the greatest embedded gain (or those assets whose sale would result in the most federal income tax, taking into consideration not only the amount but the character of the gain involved). In this regard, the drafting difficulty arises not so much with describing the upper limit on the GPOA, but in creating an ordering rule which appropriately adjusts the formula based upon the circumstances that one might reasonably expect to be applicable at the death of the surviving spouse.[11]

3. Designing the Formula. In its simplest form, the formula GPOA might apply to a pecuniary amount rather than to specific assets. However, funding such a pecuniary amount would require the trustee to determine the assets over which it applies. That discretion might result in undesired income tax consequences. In particular, distributions that satisfy a pecuniary obligation of the trust are recognition events for the trust. The fair market value of the property is treated as being received by the trust as a result of the distribution; therefore, the trust will recognize any gain or loss if the trust's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, gains or losses could be recognized by the trust if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to describing specific trust assets or a fractional share of the trust. *See* Treas. Reg. § 1.661(a)-2(f)(1); Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960 1 CB 286. As a result, one should avoid simple powers of appointment over, for example, "assets with a value equal to my [spouse's] remaining applicable exclusion amount."

On the other hand, if the surviving spouse's testamentary power potentially extends to all of the applicable property equally, but is fractionally limited, all property subject to that provision should get a fractional adjustment to basis. A pro rata adjustment would result in wasted basis adjustments, since a $1,000,000 asset with $1 gain would use just as much of the surviving spouse's applicable exclusion amount as a $1,000,000 asset with $900,000 gain. The result would be better

[10] As discussed below, this targeted estate tax inclusion and resulting basis adjustment may also be accomplished by granting the surviving spouse a limited power of appointment that is exercised in a manner to trigger the Delaware Tax Trap.

[11] Morrow notes:

> Assets that may incur higher tax rates, such as collectibles . . . would be natural candidates for preference. On the opposite end of the spectrum, other assets might have lower tax rates or exclusions, such as qualifying small business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable property, which can offset current income, before allocating to stocks, bonds, raw land, family vacation home, etc. Therefore, ultimately a weighting may be optimal, or even a formula based on tax impact, but at the most basic level practitioners would want the GPOA to apply to the most appreciated assets first.

See Morrow, fn. 9, at pp. 21-22.

than no extra basis at all, but not as optimal as the trustee limiting the surviving spouse's GPOA, or establishing an ordering rule to determine exactly which property the power pertains to.[12]

By specifying that the GPOA applies on an asset-by-asset basis to the most appreciated asset first, cascading to each next individual asset until the optimal amount is reached, the difficulty with pecuniary funding can likely be avoided. Since the ordering formula necessarily means that the GPOA could never apply to depreciated assets, the IRS would have no statutory basis to include them in the surviving spouse's estate (or accord them an adjusted basis). The GPOA would apply to specific property, and not a dollar amount or a fraction. Applying the formula would likely require the creation by the trustee of a rather elaborate spreadsheet when dealing with numerous individual assets (think of brokerage accounts with dozens of individual stock positions), but the result would be a well ordered cascade of basis increase.[13]

If the spouse serves as the (or a) trustee, might the IRS argue that he or she has an indirect power to manipulate gains and losses on investments, and therefore basis, which in effect gives the spouse a GPOA over all of the trust's assets up to the remaining applicable exclusion amount? Presumably not. Treasury Regulation Section 25.2514-1(b)(1) provides that "[t]he mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment."

4. Limiting the GPOA to Avoid Diversion of Assets and Loss of Asset Protection. Just how broad of a general power must the surviving spouse have to obtain a new cost basis? From a tax standpoint, the goal of the formula GPOA should be like an often-expressed wish for children (to be seen but not heard) or perhaps like a grantor's intent with typical *Crummey* withdrawal rights (to be granted but not exercised). After all, it is the *existence* of the GPOA that gives rise to the basis adjustment—not its exercise. The IRS has historically had every incentive to find a GPOA even on the narrowest of pretexts, since in the past, a GPOA typically produced more revenue in the form of estate tax than it lost by virtue of basis adjustments. Courts have gone along, finding a GPOA to exist even where the holder of the power didn't know it existed, or couldn't actually exercise it due to incapacity. *See, e.g., Fish v. U.S.*, 432 F2d 1278 (9th Cir 1970), *Est. of Alperstein v. Comm'r*, 613 F2d 1213 (2nd Cir 1979), *Williams v. U.S.*, 634 F2d 894 (5th Cir. 1981). The breadth of the statutory language and Treasury regulations in finding a GPOA, together with favorable law in the asset protection context, mean that GPOAs can be drafted to pose little threat to the estate plan.

If a LEPA trust (described above at page 12) is used, the general power of appointment must include the spouse or spouse's estate (and not just creditors of the spouse's estate), and must be "exercisable by such spouse alone and in all events." IRC § 2056(b)(5). However, if no marital deduction is to be claimed, as is typically the case with a bypass trust OBIT, some limitations may be included.

For example, a GPOA may limit the scope of eligible beneficiaries so long as creditors of the power holder are included. As an illustration:

> My [spouse] shall have a testamentary power to appoint, outright or in trust, any property remaining in the trust to any one or more persons related to me by blood, marriage or adoption or to any charity or charities. In addition, my [spouse] shall have a testamentary power to appoint [optimal trust property] to the creditors of [his/her] estate.

[12] Morrow suggests that an independent trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the surviving spouse's GPOA. The trustee's fiduciary power could arguably limit the spouse's GPOA over only specific assets chosen by the trustee, since the trustee's power would also be limited. While this is fundamentally different in many ways from traditional marital deduction funding formulas that involve trustee choice, the IRS could conceivably seek to apply a "fairly representative" requirement, or otherwise impose limits on trustee authority comparable to those described in Rev. Rul. 64-19, 1964-1 CB 682. *See* Davis, *Funding Unfunded Testamentary Trusts*, 48 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 8, ¶ 804.3 (2014). Morrow concludes that the more conservative and simpler approach is probably just to make it clear that the GPOA never applies to the less appreciated assets, and is never subject to any power holder's discretionary choice.

[13] For a formula that seeks to exercise a power of appointment in this cascading asset-by-asset fashion (although in the context of springing the "Delaware Tax Trap" discussed below, see Exhibit B.

See IRC § 2041(b)(1); Treas. Reg. § 20.2041 3(c)(2); *Jenkins v. U.S.*, 428 F2d 538, 544 (5th Cir. 1970).

Furthermore, as noted earlier, a general power is still a GPOA if it may only be exercised with the consent of a non-adverse party. IRC § 2041(b)(1)(C)(ii). In fact, even a trustee with fiduciary duties to adverse beneficiaries is not, by that status alone, considered adverse. *See Est. of Jones v. Comm'*r, 56 TC 35 (1971); *Miller v. U.S.*, 387 F2d 866 (1968); Treas. Reg. § 20.2041-3(c)(2), Ex. 3. For example, one might add to the above language: "However, my [spouse] may exercise [his/her] power of appointment only with the consent of [name of non-adverse party, and/or] the trustee, who must be a non-adverse party." The document would then need to include provisions to enable appointment of a non-adverse party as trustee if, for instance, the spouse was the trustee. If a non-adverse party is named, it would be prudent to name alternates in the event the first is deceased or incapacitated.[14]

Moreover, a GPOA is "considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised." Treas. Reg. § 20.2041-3(b). Including these sorts of requirements would make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a Treasury regulation.

5. Exposure to Creditors. Does granting a surviving spouse a testamentary power to appoint trust property to the creditors of his or her estate mean that those creditors can reach the trust property even if the property is not so appointed? The answer will depend upon local law. For example, it would not appear so in Texas. The spendthrift provisions of the Texas Trust Code generally permit a settlor to provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. TEX. PROP. CODE § 112.035. While these provisions do not apply to trusts of which the settlor of the trust is also a beneficiary, Texas law makes clear that a beneficiary of the trust may not be considered to be a settlor, to have made a voluntary or involuntary transfer of the beneficiary's interest in the trust, or to have the power to make a voluntary or involuntary transfer of the beneficiary's interest in the trust, merely because the beneficiary, in any capacity, holds or exercises a testamentary power of appointment. *Id.* at (f)(2). This rule is in contrast to the exposure of a *presently exercisable* general power, which will be discussed below.[15]

C. Using the Delaware Tax Trap Instead of a GPOA to Optimize Basis

Normally, holding or exercising a limited testamentary power of appointment does not cause estate tax inclusion. IRC § 2041(b)(1)(A). However, estate tax inclusion does result if the power is exercised

> by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

IRC § 2041(a)(3).[16]

Exercising a power of appointment in this manner triggers the so-called "Delaware Tax Trap" ("DTT"). If the surviving spouse exercises the power in this fashion, the property so appointed is includable in the surviving spouse's estate for federal estate tax purposes, and therefore receives a new cost basis upon the death of the surviving spouse. IRC § 1014(b)(9). As indicated above, an OBIT may be designed to grant a carefully tailored GPOA to the surviving spouse to achieve optimum basis increase. But what if your client does not want to grant his or her spouse a general power of

[14] The use of a non-adverse party in this context should be contrasted with the problems under Code Section 2041(b)(1)(C) discussed at page 20-21 above regarding naming a third party with the right to grant the spouse a general power of appointment. In the present context, the spouse already holds the optimum power; the requirement of consent from a third party is included only to make it harder for the spouse to actually exercise the power in a manner inconsistent with the grantor's wishes.

[15] Whether a power of appointment is testamentary or a lifetime (presently exercisable) GPOA also makes a difference in bankruptcy. *See* 11 USC ' 541(a)(1), (b)(1), (c).

[16] *See also* Treas. Reg. § 20.2041-3(e). There is a gift tax analog, IRC § 2514(e), but triggering gift tax only increases basis to the extent of gift tax actually paid, so its application is extremely limited.

appointment, no matter how narrowly drawn? Or what if you are dealing with an existing funded bypass trust that lacks such a formula power? The Delaware Tax Trap can be used to accomplish the same result with a *limited* power of appointment. The technique involves the affirmative use of what has previously been perceived as a tax "pitfall" in the rules involving the exercise of limited powers of appointment.

1. General Principles. While applying the DTT to specific situations can be somewhat complex, the statutory language noted above is relatively straightforward. The statute causes property to be included in the power holder's estate, even if the power holder has only a limited power of appointment, if it is *actually exercised* in a way that restarts the running of the Rule Against Perpetuities without regard to the date that the original power of appointment was created. Since exercising a limited power of appointment (usually thought of as "safe" for estate tax purposes) in a way that restarts the Rule Against Perpetuities might cause inadvertent estate tax inclusion, many states have enacted "savings clauses" into their statutes that restrict the ability of the holder of a limited power to trigger the trap in most instances. [17] In addition, some estate planning attorneys have drafted tightly drawn Rule Against Perpetuities savings clauses in Wills or trust agreements that prevent limited powers of appointment from being exercised in a way to trigger the trap. If the drafting language does not prevent triggering the trap, then despite most state law restriction, there is usually one method left out of state savings statutes that appears to be available in most states.[18]

2. Granting a PEG Power. Specifically, if the surviving spouse holds a *limited* power of appointment which permits appointment in further trust, and the surviving spouse appoints trust assets into a separate trust which gives a beneficiary a *presently exercisable general* power of appointment (sometimes referred to as a "PEG power"), the appointment would, under common law, reset the "clock" on the running of the Rule Against Perpetuities. *See* RESTATEMENT (THIRD) OF TRUSTS § 56 cmt. b. This exercise thereby "postpones the vesting" for a period "ascertainable without regard to the date of the creation of [the spouse's limited] power." The effect of postponing vesting is to trigger Code Section 2041(a)(3), causing the appointed property to be included in the surviving spouse's estate for federal estate tax purposes. Estate tax inclusion results in an adjustment to the basis of the property under Code Section 1014(b)(9).

Might an argument be made that in order to trigger estate tax inclusion, the power must be exercised in favor of someone other than the person who would receive the property in default of the exercise? Fortunately, Treasury regulations make it clear that is not the case. Treasury Regulation Section 20.2041-1(d) provides: ". . . a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment."

3. Gaining a Step-Up. Issues associated with springing the DTT could themselves be the subject of an entire seminar, but suffice it to say that under common law, for the surviving spouse to exercise the power of appointment in order to cause estate tax inclusion, he or she must effectively grant someone a presently exercisable general power of appointment. Thus, for example, the surviving spouse could appoint low-basis bypass trust property into trusts for his or her children which then grant the children inter vivos general powers of appointment.[19] The exercise of a limited power of appointment in this manner would permit the children to appoint the property in further trust, restarting the applicable Rule Against Perpetuities. As a result, the exercise of the limited power of appointment would

[17] For a survey of state law provisions, *see* Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law*, specifically pp. 8-10 available at: http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. *See also* Blattmachr and Pennell, *Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes*, 68 J. OF TAX'N 242 (1988); Blattmachr and Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the Delaware Tax Trap*, 24 REAL PROP. PROB. & TR. J. 75 (1989). While the cited articles do not discuss using the DTT for basis planning, the discussion is nevertheless helpful. *See also*, Spica, A *Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, 41 RPTL J., 167 (Spring 2006); Greer, *The Delaware Tax Trap and the Rule Against Perpetuities*, EST. PL. J. (Feb. 2001); Culler, *Revising the RAP*, PROB. L. J. OF OHIO (Mar./Apr. 2012).

[18] Somewhat ironically, Delaware has amended its Rule Against Perpetuities statute to preclude use of the Delaware Tax Trap for trusts with a zero inclusion ratio for GST purposes, which would include most bypass trusts. 25 DEL. CODE §§ 501, 504.

[19] Treas. Reg. § 20.2041-3(e)(2).

generate a step-up in basis at the surviving spouse's death under Section 1014(b)(9) of the Code.

4. Drafting to Enable Use of the DTT. The use of the DTT strategy does not require any particularly complex drafting in the bypass trust. It should be sufficient that the trust grants the surviving spouse a limited testamentary power of appointment, and that any Rule Against Perpetuities savings clause in the Will does not prevent exercising that power in a manner that restarts the Rule. The surviving spouse will need to draft a Will that exercises the power in a very precise manner, either by expressly exercising it over specific assets whose combination of basis increase and value create favorable tax results, or by exercising it in a formula manner to achieve optimal basis adjustment results. The cascading asset-by-asset formula approach described above beginning on page 16 with regard to formula GPOAs could be adapted to cause this result. Sample language providing for a formula exercise of the Delaware Tax Trap is included as Exhibit B.

5. Costs of Using the DTT. Granting a beneficiary a PEG power impairs asset protection much more than does granting a testamentary power. In most states, the creditor of someone holding only a testamentary power of appointment cannot attach trust assets, even upon the death of a beneficiary. In contrast, if the beneficiary holds an inter vivos general power of appointment, exposure of trust assets to a beneficiary's creditors is not limited by spendthrift language. When a PEG power is granted, a beneficiary's creditors can reach any of the trust's assets at any time. In addition, a PEG power may preclude shifting taxable income to other trust beneficiaries, because a presently exercisable general power causes the trust to be treated as a grantor trust as to the beneficiary—the trust's income is taxed to the holder of the power if it is exercisable solely by the power holder. IRC § 678. Moreover, the PEG power prevents the beneficiary from making gift-tax-free distributions of trust property to other trust beneficiaries, and results in state and federal estate taxation inclusion (and a possible step-down in basis) at the time of the power holder's death. IRC §§ 2041, 1014(b)(4). These disadvantages may make using the DTT to harvest a basis adjustment an unattractive tool, especially for clients who wish to use lifetime trusts for their children's inheritance. The "price" of new cost basis when the surviving spouse dies is creditor exposure and estate tax inclusion for the person to whom the PEG power is granted. It may, however, be the only tool available (if a somewhat unpalatable one) in the context of preexisting irrevocable trusts that already contain limited powers of appointment. And if the existing bypass trust terminates in favor of children outright anyway, and no disclaimer funding is anticipated, this route may be the easiest and most flexible to take. Note that a "disclaimer bypass" plan would generally not permit use of the DTT since, as noted earlier, disclaiming into the trust precludes (or at least markedly limits) the spouse from retaining a limited power of appointment which is necessary to "spring" the DTT.

6. Mitigating the Costs. If the spouse wishes to preserve creditor protections for the children, he or she could presumably appoint the assets into trust for them, but grant some *other party* the PEG power. Note, though, that whomever holds the power would have estate tax inclusion of the assets subject to the power (or would be treated as having made a gift if the power were released), and the assets would be subject to the claims of that person's creditors. So long as the person holding the PEG power has applicable exclusion amount (and GST tax exemption) to spare, however, the property could continue in GST tax-exempt creditor-protected trusts for the children.

PEG powers might force the next generation to obtain a new cost basis at the expense of foregoing asset protection, income shifting, and GST tax exemption. These difficulties could be avoided if states would amend their Rule Against Perpetuities statutes (or their statutes governing powers of appointment) to permit the exercise of limited powers of appointment to restart the Rule Against Perpetuities by creating further *limited* powers, instead of PEG powers, while expressly declaring an intention to thereby trigger the DTT.

D. Is the DTT Safer than a Formula GPOA? Some practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that the surviving spouse's control of his or her net taxable estate value (either through spending, or by leaving assets to charity or new spouse), may permit indirect control of the value of the assets in the bypass trust subject to the formula GPOA. If that argument were to prevail, the IRS might seek to include all of the bypass trust assets in the surviving spouse's estate, and not just the "optimum" amount. Proponents of the formula GPOA approach note that formula funding clauses based on a surviving spouse's available GST tax exemption amount have been used for decades in GST tax non-exempt trusts without giving rise to this argument by the IRS.[20] However, there is some plausibility to the argument.

1. *Estate of Kurz.* With regard to this issue, the *Estate of Kurz,* 101 TC 44 (1993), *aff'd* 68 F3d 1027 (7th Cir. 1995) is instructive. In *Kurz*, the husband's estate plan provided for a marital trust that gave his wife an unrestricted lifetime GPOA. The bypass trust provided that if the marital trust was exhausted, the wife also had a lifetime 5% withdrawal power over the bypass trust. Upon the wife's death, the IRS argued that not only was the marital trust included in the wife's estate, but that 5% of the bypass trust was also included. The estate argued that the 5% was not in the estate because the marital trust had not been exhausted by the time of the wife's death, so the condition precedent to her 5% withdrawal right had not been met.

The IRS contended that all the wife needed to do to obtain 5% of the bypass trust assets was to withdraw or appoint the assets in the marital trust. Both the Tax Court and the appellate court agreed with the IRS, concluding that the wife held a GPOA over 5% of the bypass trust's assets since she could effectively withdraw the 5% at any time, for any reason, without affecting her estate, during her lifetime.

The Tax Court's rationale was that the condition precedent cited by the estate was illusory and lacked any independent non-tax consequence or significance. The appellate court preferred a test that looked through the formalities to determine how much wealth the decedent actually controlled at the time of her death. It looked to examples in the relevant Treasury regulations and noted that the examples of contingencies which precluded inclusion were not easily or quickly controlled by the power holder.

2. Impact of *Kurz*. Interestingly, both sides of the debate on formula GPOA clauses cite *Kurz*. Opponents note that the amount of the formula GPOA in the bypass trust is conditioned upon the size of the surviving spouse's taxable estate, and since the surviving spouse has the ability to control that (through lifetime or testamentary charitable or marital gifts, or through consumption of his or her assets), the amount of the property subject to the formula GPOA is likewise in his or her control. Proponents of formula GPOA clauses (like OBIT advocate Morrow) note that the typical formula GPOA clause is not a *lifetime* GPOA.

> More importantly, unlike *Kurz*, it is not subject to a condition precedent, nor does the capping of the GPOA hinge **at all** on Treas. Reg. § 20.2041-3(b) [regarding conditional powers of appointment]—it is pursuant to other treasury regulations cited herein [specifically, Treas. Reg. § 20.2041-1(b)(3): Powers over a portion of property]. Additionally, unlike the ability of a beneficiary to withdraw at will as in *Kurz*, which the appellate court deemed "barely comes within the common understanding of 'event or . . . contingency'", the ability of an OBIT formula GPOA powerholder (if it would otherwise be capped) to increase their testamentary GPOA would require giving away or spending a significant portion of their assets (quite unlike *Kurz)*—a significant "non-tax consequence" if there ever was one.[21]

Until greater certainty is provided on the issues, whether by the IRS or the courts, some practitioners may prefer avoiding even the hint of a *Kurz*-type argument against formula GPOA caps. The more conservative approach would be to require the GPOA formula to be applied, ignoring any charitable or marital deduction otherwise available to the surviving spouse's estate.[22] In most cases and estate plans, spouses are unlikely to be making large charitable or marital gifts, so ignoring these adjustments is unlikely to make much if any difference.

Unlike a formula GPOA, the Delaware Tax Trap is only applicable to the extent that the surviving spouse affirmatively exercises his or her limited power of appointment ("LPOA") to trigger the trap. There is no danger of the mere existence of an LPOA (or a lapse of an LPOA) causing inclusion under Code Section 2041(a)(3) just because the surviving spouse has the authority to exercise it. Therefore, using the Delaware Tax Trap technique is immune from *Kurz*-type arguments. As a result, many attorneys may prefer it.

VI. Other Strategies For Basis Adjustment

A. Transmuting Separate Property into Community Property

As noted earlier, a basis adjustment at death applies not

[20] *See* Morrow, fn. 9, at p. 21.
[21] Morrow, fn. 9, at p. 37.

[22] *See* Nunan, *Basis Harvesting*, PROB & PROP., (Sept./Oct. 2011) (which includes sample language in appendix with both options).

only to the decedent's interest in community property but also to property which represents the surviving spouse's one-half share of community property IRC § 1014(b)(6). Therefore, a strategy to obtain an increase in basis may be to transmute low-basis separate property into community property. Doing so ensures that no matter which order the spouses' deaths may occur, the surviving spouse will receive a new cost basis in the property. On the other hand, if property is transmuted, all or part of the separate property being converted to community property may become subject to the liabilities of both spouses. In addition, all or part of the separate property being converted to community property may become subject to either the joint management, control, and disposition of both spouses or the sole management, control, and disposition of the other spouse alone. Finally, of course, if the marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of the spouse or the spouse's heirs.

B. Transferring Low Basis Assets to the Taxpayer

Since assets owned by an individual may receive a new cost basis at death, taxpayers may consider transferring low basis assets to a person with a shortened life expectancy, with the understanding that the person will return the property at death by Will or other arrangement. This basis "gaming" may be easier in an environment with substantial estate and gift tax exemptions, since those exemptions may be used to avoid transfer tax on both the gift and the subsequent inheritance. If the person to whom the assets are initially transferred does not have a taxable estate, substantial additional assets may be transferred, and a new basis obtained, without exposure to estate tax.

1. Gifts Received Prior to Death. Congress is aware that someone could acquire an artificial step-up in basis by giving property to a terminally ill person, and receiving it back with a new basis upon that person's death. As a result, the Code prohibits a step-up in basis for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor (or to the spouse of the donor) as a result of the decedent's death. IRC § 1014(e). A new basis is achieved only if the taxpayer lives for at least one year after receipt of the property.

2. Granting a General Power. Rather than giving property to a terminally ill individual, suppose that you simply grant that person a general power of appointment over the property. For example, H could create a revocable trust, funded with low basis assets, and grant W a general power of appointment over the assets in the trust. The general power of appointment will cause the property in the trust to be included in W's estate under Section 2041(a)(2) of the Code. In that event, the property should receive a new cost basis upon W's death. IRC § 1014(b)(9). The IRS takes the position that the principles of Section 1014(e) apply in this circumstance if H reacquires the property, due either to the exercise or non-exercise of the power by W. *See* PLR 200101021 ("Section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment.", citing H.R. Rept. 97 201, 97th Cong., 1st Sess. (July 24, 1981)). If W were to actually exercise the power in favor of (or the taker in default was) another taxpayer, such as a bypass-style trust for H and their descendants, the result should be different.

C. Transferring High Basis Assets to Grantor Trust

An intentionally defective grantor trust is one in which the grantor of the trust is treated as the owner of the trust property for federal income tax purposes, but not for gift or estate tax purposes. If the taxpayer created an intentionally defective grantor trust during his or her lifetime, he or she may consider transferring high basis assets to that trust, in exchange for low basis assets of the same value owned by the trust. The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange for federal income tax purposes. Rev. Rul. 85-13, 1985-1 CB 184. The effect of the exchange, however, will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis at death. But for the exchange of these assets, the low basis assets formerly held by the trust would not have acquired a step-up in basis as a result of the grantor's death. At the same time, if the grantor transfers assets with a basis in excess of fair market value to the trust, those assets will avoid being subject to a step-down in basis at death. Since the grantor is treated for income tax purposes as the owner of all of the assets prior to death, the one-year look-back of Section 1014(e) of the Code should not apply to limit the step-up in basis of the exchanged assets.

D. Capturing Capital Losses

If a terminally ill individual has incurred capital gains during the year, he or she may consider disposing of

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high basis assets at a loss during his or her lifetime, in order to recognize capital losses to shelter any gains already incurred during the year. As noted earlier, assets the basis of which exceed their fair market value receive a reduced basis at death, foreclosing recognition of these built-in capital losses after death. Moreover, losses recognized by the estate after death will not be available to shelter capital gains recognized by the individual before death. If, on the other hand, the individual has recognized net capital losses, he or she may sell appreciated assets before death with impunity. Net capital losses are not carried forward to the individual's estate after death, and as a result, they are simply lost. Rev. Rul. 74-175, 1974-1 CB 52.

E. Sales to "Accidentally Perfect Grantor Trusts"

With a much larger federal estate tax exemption, maybe we should consider standing some traditional estate planning tools on their heads. Instead of an intentionally defective grantor trust, why not create an "Accidentally Perfect Grantor Trust" ("APGT")? Although the concept is somewhat different, in the right circumstances, the benefits could be dramatic. The typical candidate is a self-made individual whose parents are people of modest means. Using this technique can actually benefit the donor fairly directly, in a tax-advantaged way.

The Technique. An APGT is a trust established by a junior family member for the benefit of his or her parent or a more senior family member. Junior gives low-basis or highly appreciating assets to the trust. Alternatively, junior structures the trust as an intentionally defective grantor trust ("IDGT"), contributes appropriate "seed" money, and loans money to the trust to buy an asset with lots of appreciation potential from junior. Initially, the trust might be set up for the benefit of the senior generation (or for junior's parents and descendants). But this trust has a twist. From day one, the trust has language built into it that causes the trust assets to be *included in the estate of the senior generation family member for federal estate tax purposes*. Note that a similar effect could be achieved by having the junior family member give property to the senior family member with the hope that the senior family member bequeaths the property back to junior in trust. The APGT, however, allows junior to use less of junior's gift tax exemption (by selling to the IDGT for a note), and allows junior to prescribe the terms of the trust and protect assets from the creditors of the senior family member. In addition, depending upon the structure, the resulting trust may be a grantor trust as to junior even after the senior generation family member is gone, providing a vehicle for future tax planning.

Example 11: Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $100,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary to make sure that the sale is respected for income and gift tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment). When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2 million. The value of the trust assets, when added to the value of Mary's other assets, is well below her available estate tax exemption. Mary's executor uses some of her GST tax exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property: (i) it can't be attached by her creditors; (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax; (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax; and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Specifics.

1. Structure of the APGT. Although the term "accidentally perfect" distinguishes this trust from an "intentionally defective" trust, there nothing accidental about it. The key to the success of an APGT is the creation by a junior family member of an irrevocable trust that (i) successfully avoids estate tax inclusion for the junior family member under Sections 2036 through 2038 of the Code; but (ii) which will intentionally cause estate tax inclusion for a senior family member who has estate tax (and GSTT) exemption to spare. The APGT would typically be structured as an IDGT, and if a sale is involved, it would buy rapidly appreciating assets from the junior family member. It would maintain its grantor trust status at least until the purchase price is paid. The difference is that the agreement establishing the APGT also grants a senior family member a general power of appointment over the trust, thereby ensuring inclusion of the trust assets in his or her taxable estate (and thereby ensuring a new cost basis at the time of the senior family member's death). The amount of the APGT's property subject to the general power could be limited by a formula to ensure that (i) only appreciated non-IRD assets could be appointed; and (ii) inclusion of those assets in the senior family member's taxable estate doesn't cause estate tax to be payable when that person dies. When the junior family member sells appreciating assets to the APGT, its IDGT provisions ensure that the sale is ignored for federal income tax purposes. *See* Rev. Rul. 85-13, 1985-1 CB 184. Nevertheless, the assets are subject to estate tax (with the attendant income and GSTT benefits) upon the death of the senior family member.

2. Basis Issues. If the senior family member exercises the power of appointment, the assets of the APGT receive a new cost basis pursuant to Section 1014(b)(4). But even if the power of appointment is not exercised, the assets of the APGT are included in determining the value of the estate of the senior family member under Code Section 2041(a)(2). As a result, those assets receive a new cost basis in the hands of the taxpayer to whom they pass. IRC § 1014(b)(9). If the junior family member gives assets to a senior family member, and those same assets are inherited by the donor (or the donor's spouse) within one year, there is no step-up in the basis of the assets. IRC § 1014(e). With an APGT, however, upon the death of the senior family member, the assets do not pass back to the donor/junior family member, but to a different taxpayer—a dynasty trust of which the donor/junior family member happens to be a beneficiary. Although the IRS has privately ruled otherwise, (*see, e.g.*, PLR 200101021), the fact that the recipient of the property is a trust, and not the donor, might permit a new basis, even if the senior family member dies within a year of the assets being given to the APGT. Of course, if the senior family member survives for more than a year, the limitations under Section 1014(e) won't apply. Suppose that the junior family member sold assets to the trust for a note? If the asset is worth $1 million, but is subject to a debt of $900,000, then presumably only $100,000 is includable in the senior family member's estate. Nevertheless, the basis adjustment for the asset should be adjusted to its $1 million value, and not just $100,000. See *Crane v. Comm'r*, 331 U.S. 1 (1947). Note that if the power of appointment is not exercised by the senior family member, the basis adjustment arises under Code Section 1014(b)(9) instead of Section 1014(b)(4). Section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the APGT is a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The Section 1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the APGT remains a grantor trust as to the junior family member after the senior family member's death, then the amount of the basis adjustment might be reduced by the amount of the deductions allowed to the junior family member prior to the senior family member's death. *See* Treas. Reg. § 1.1014-6.

3. Impact of Interest Rates. As with IDGTs, when interest rates are low, sales to APGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low hurdle rate set by the IRS for the note. Remember, in a sale context, it is the growth in excess of the purchase price (plus the AFR on any part of the deferred purchase price) that is kept out of the estate of the junior family member, and instead ultimately lands in a dynasty trust for the junior family member.

4. Benefit to Heirs. The property in the APGT passes to a new dynasty trust for the ultimate beneficiaries (typically one or more generations of junior family members). With a sale to an APGT, if the contributed assets grow faster than the interest rate on the IDGT's note, the excess growth passes back to the grantor of the APGT. The goal of an APGT is the same regardless: The assets ultimately pass back for the benefit of the grantor in a creditor-proof, estate-tax exempt, and GST-tax exempt trust, and with a new cost basis equal to the fair market value of the trust assets at the time of the senior family member's death, all without estate tax, and possibly without gift tax.

5. Income Tax Issues. What is the income tax status of the dynasty trust that is formed after the death of the senior family member? If the successor dynasty trust arises as a result of the failure of the senior-generation family member to exercise the power of appointment, one can make a compelling argument that the trust can be characterized as a grantor trust as to the junior family member, since he or she is the only transferor of property to the trust. Treas. Reg. § 1.671-

2(e)(5). On the other hand, if the successor trust arises as a result of the senior family member actually exercising the power of appointment, then the senior family member will be treated as the grantor of the successor dynasty trust, even if the junior family member is treated as the owner of the original trust. *Id*. The regulations thus appear to provide the client with a choice, to be made by the selection of language in the senior generation family member's Will, to decide whether the successor trust will be a "defective" trust as to the junior family member after the death of the senior family member. If grantor trust treatment is maintained, the resulting trust would have the features of a so-called "beneficiary defective grantor trust" after the death of the senior family member. *See, e.g,*. Hesch et al., "A Gift from Above: Estate Planning on a Higher Plane," 150 TR. & EST., Nov. 2011, at 17; Oshins and Ice, "The Inheritor's Trust™; The Art of Properly Inheriting Property," EST. PL., Sept. 2002, at 419.

6. Estate Tax Issues. As noted above, estate tax inclusion in the estate of the senior family member (with its resulting basis adjustment) is one of the goals of the APGT. But can the IRS argue that the dynasty trust that arises for the benefit of the junior family member after the death of senior is includable in junior's estate? As noted above, junior may be treated as the grantor of the resulting trust for income tax purposes. For estate tax purposes, however, the existence of the power of appointment in the senior family member results in a new transferor. So long as the resulting trust limits junior's access to those rights normally associated with a descendant's or dynasty trust (e.g., limiting junior's right to make distributions to him- or herself by an ascertainable standard, and allowing only limited powers of appointment), there should be no inclusion of the trust's assets in junior's estate at the time of his or her later death. *See* PLR 200210051. *See also* PLRs 200403094; 200604028. Thanks to a recent change to the Texas Trust Code, regardless of whether the senior family member exercises her power of appointment, the trust will not be treated as having been created by the junior family member for purposes of applying the Texas spendthrift protection statute. *See* TEX. PROP. CODE § 112.035(g)(3)(B). As a result, the IRS should not be able to assert that Section 2041(a)(2) of the Code (transfer with a retained right to appoint property to one's creditors) applies to subject the resulting trust to estate tax in junior's estate.

7. GST Tax Issues. The donor can allocate GSTT exemption to any gift to the APGT, but if the entire trust is expected to be included in the taxable estate of the senior family member, the donor would probably not do so. To maximize the benefits, the executor of the estate of the senior family member can allocate GSTT exemption to property subject to the general power of appointment. *See* IRC § 2652(a)(1)(A); Treas. Reg. § 26.2652-1. As a result of allocation, the dynasty trust that receives the APGT assets will have a GST tax inclusion ratio of zero, which means that all of those assets (both the seed money and the growth) can pass into trust for the APGT grantor, and ultimately on to grandchildren or more remote generations, with no additional estate or gift tax. This multi-generational feature makes a sale to an APGT a very powerful transfer tax tool.

8. Selling Discounted Assets. As with sales to more traditional intentionally defective grantor trusts, rapidly appreciating or leveraged assets are ideal candidates for sale. The use of lack-of-marketability and minority interest discounts can increase the benefits of the technique.

F. Section 754 Elections

Upon a partner's death (or upon the sale or exchange of a partnership interest) the partnership's basis in property owned by the partnership is adjusted under Code Section 743 if the partnership makes (or has in effect) an election under Code Section 754. While the implications and mechanics of Section 754 elections are well beyond the scope of this outline, most commentators agree that it is advantageous to estate beneficiaries to have the partnership make a Section 754 election as of the year of death if the fair market value (and hence basis) of the decedent's interest in the partnership exceeds the decedent's share in the basis of the partnership's assets. Remember that for partnerships (and other entities treated as partnerships for federal income tax purposes), there are two different types of basis. One is the basis of property owned by the partnership (referred to as "inside basis"). But for most tax purposes, the partners are not treated as the owners of those assets; they instead own partnership interests (or LLC membership interests). Each partner separately maintains a basis in that interest (referred to as "outside basis"). If a partnership interest is transferred (including transfers arising at death), and if the basis of the transferee partner's partnership interest (the outside basis) is greater than the former partner's share of the partnership's "inside" basis in the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets. As a result, if the partnership thereafter depreciates an asset, the transferee

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partner's share of depreciation will be higher. Likewise, if the partnership later sells an asset, the transferee's share of gain on the sale of the asset will be lower. The basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is a function of the relationship between the "outside" basis in the partnership interest and the partnership's "inside" basis in its assets which are allocable to that partner. If a partnership does not make a Section 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which might also be an event triggering a basis adjustment.[23]

G. Other Partnership Planning Opportunities

There are a number of basis management tools for practitioners who are willing to master the complex tax rules that arise with respect to basis for partners and partnerships. As noted above, the difference between a partner's "outside" basis in a partnership interest and the partnership's "inside" basis in its assets can give rise to opportunities to obtain favorable basis adjustments upon the death of a partner. These opportunities typically arise because of a rule that, in most cases, allow partnerships to distribute non-cash assets to partners without either the partnership or the partner recognizing any gain. Generally, a partner that receives a distribution in kind from a partnership receives a carryover basis in any distributed asset, and reduces his or her "outside" basis in the partnership by the basis of the asset received. If the partnership's "inside" basis in the distributed asset exceeds the partner's "outside" basis in his or her partnership interest, however, the basis in the partner's "outside" basis in the partnership interest becomes the partner's basis in the property received, and the partner's basis in his or her partnership interest goes to zero. *See* IRC §§ 732(a)(1), 733. Thus, for example, if a partner with a $50,000 outside basis receives a partnership asset worth $100,000, but with an inside basis of only $10,000, the distributee partner recognizes no gain, but instead takes a $10,000 basis in the distributed property and reduces his or her "outside" basis in the partnership interest by a corresponding amount. If instead the partnership's basis in the distributed asset was $60,000, then the partner's basis in the asset would be $50,000 and the "outside" basis in his or her partnership interest would be reduced to zero. In either event, if the distributed asset and/or the partnership interest are held at the time of the partner's death, they would receive a new cost basis equal to their fair market value at that time, and if the partner's estate or heirs ultimately sold the asset, the substantial built-in gain would not be recognized. These rules can be complex, especially if the partnership property is encumbered by debt. *See* IRC § 752. In addition, special rules may apply if the partnership holds so-called "hot assets" (generally, ordinary income assets such as unrealized receivables or substantially appreciated inventory), which might cause the partner to recognize income upon distribution of assets, even if the only assets distributed are capital assets. *See* IRC § 751.[24]

VII. CONCLUSION

With the enactment of "permanent" estate, gift, and GST laws, much of the uncertainty that has existed for the last several years has been quelled. The simultaneous existence of very large estate tax exemptions that will continue to grow, together with the added permanence of portability and the imposition of higher income tax rates and new income taxes, changes the conversations that we have with clients during the estate planning and the estate administration process. These changes have reduced estate tax savings opportunities for many of our clients, but may bring income tax savings techniques to the fore. The negative impact on income taxes that flow from the use of traditional estate planning tools are now more pronounced. As a result, those techniques may need to be re-evaluated and adapted to minimize their negative impact. Adding features to an estate plan to obtain basis is likely to have increasing importance to our clients. As always, even with permanence, we live in an ever changing but never boring world of estate planning.

23 *See* Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," at section II.O.7.c.iii (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter "Gorin's Business Succession Solutions").

24 For a more thorough discussion, see Yuhas and Radom, "The New Estate Planning Frontier: Increasing Basis," J OF TAX'N (Jan. 2015), 3, 13-23.

EXHIBIT A

Sample *Clayton* QTIP Trust Language

1. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, so elects for some or all of my net residuary estate to qualify for the federal estate tax marital deduction under Section 2056(b)(7) of the Code (the "QTIP election"), I direct that my net residuary estate shall be divided into two portions, to be known as Portion A and Portion B.

a. Portion A shall consist of that share of my net residuary estate, if any, with respect to which my Executor has made the QTIP election. I give, devise and bequeath Portion A to the Trustee hereinafter named, IN TRUST, to be held as a separate [QTIP] trust and disposed of in accordance with the provisions of paragraph ___ of Article ______.

b. Portion B shall consist of the balance, if any, of my net residuary estate. I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article _____.

2. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, does not make a QTIP election with respect to some or all of my net residuary estate, I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article ______.

3. Each of Portion A and Portion B is intended to be a fractional share which participates in appreciation and depreciation occurring in the property disposed of under this Article. Subject to the provisions of paragraph ___ of Article ______, each portion may be funded with cash or other property, or a combination thereof, and any such other property so used shall be valued as of the date of distribution.

EXHIBIT B

Sample Exercise of Formula Power of Appointment Triggering the Delaware Tax Trap[25]

2.3. Exercise of Powers of Appointment.

A. Identification of Power. Under the Last Will and Testament of my deceased [spouse] dated _________, ("my [spouse]'s Will") the _________ Trust (the "Trust") was created for my primary benefit. Pursuant to Section ___ of my [spouse]'s Will, I have a Testamentary Power of Appointment to appoint all of the remaining property of the Trust (outright, in trust, or otherwise) to any one or more of my [spouse]'s descendants.

B. Exercise of Power. I hereby appoint the property described in Subsection 2.3.C. below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article ___ (providing for lifetime Descendant's Trusts [*that grants the primary beneficiary thereof a presently exercisable general power of appointment*] for my children and other descendants).

C. Extent of Exercise. The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal estate tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section 2.3 shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section 2.3 shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

D. Statement of Intent. It is my intention by the foregoing exercise of my power of appointment to trigger Code Section 2041(a)(3) by postponing the vesting of an estate or interest in the property which was subject to the power for a period ascertainable without regard to the date of the creation of my power, and to thereby obtain for the assets of the Trust the maximum possible increase in the cost basis of those assets as may be permitted under Code Section 1014 as a result of my death without causing any increase in the federal estate tax and state death taxes payable from all sources by reason of my death. This Will shall be administered and interpreted in a manner consistent with this intent. Any provision of this Will which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

[25] This language is loosely adapted from Morrow, "The Optimal Basis Increase and Income Tax Efficiency Trust" available at http://healthcarefinancials.files.wordpress.com/2013/11/optimal-basis-increase-trust-sept-2013.pdf at pp. 86-87.

TAX SECTION
State Bar of Texas

April 24, 2015

Via E-Mail to Notice.Comments@irscounsel.treas.gov

Mr. John Koskinen
Commissioner
Internal Revenue Service
Attn: CC:PA:LPD:PR
(Rev. Proc. 2015-20), Room 5203
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on *De Minimis* Safe Harbor of Treas. Reg. § 1.263(a)-1(f)

Dear Commissioner Koskinen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS" or the "Service") in Rev. Proc. 2015-20, 2015-9 I.R.B. 694, for comments concerning whether it is appropriate to increase the *de minimis* safe harbor limit provided in Treas. Reg. § 1.263(a)-1(f)(1)(ii)(D), for a taxpayer without an applicable financial statement ("AFS"), to an amount greater than $500.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION 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 TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, 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 MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Service for the time and thought that has been put into simplifying taxpayer compliance with the final regulations on deduction and capitalization of expenditures related to tangible property, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Robert D Probasco, for

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

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COMMENTS ON THE *DE MINIMIS* SAFE HARBOR LIMITATION PROVIDED IN REG. § 1.263(a)-1(f)(ii)(D) FOR A TAXPAYER WITHOUT AN AFS

These comments on the *de minimis* safe harbor limitation of Treas. Reg. § 1.263(a)-1(f)(ii)(D) ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Bruce A. McGovern. Shawn R. O'Brien reviewed and provided substantive suggestions. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Michael Threet reviewed the Comments and made substantive suggestions on behalf of COGS. Robert Probasco, Chair of COGS, also reviewed these Comments.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (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 these Comments.

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Date: April 24, 2015

These comments are provided in response to the request of Treasury and the Service in Rev. Proc. 2015-20, 2015-9 I.R.B. 694, for comments concerning whether it is appropriate to increase the *de minimis* safe harbor limit provided in Treas. Reg. § 1.263(a)-1(f)(1)(ii)(D)[1] for a taxpayer without an AFS to an amount greater than $500. The Tax Section commends the efforts of Treasury and the Service to simplify taxpayer compliance with the final regulations on deduction and capitalization of expenditures related to tangible property.

RECOMMENDATION

We recommend that the safe harbor limit in Treas. Reg. § 1.263(a)-1(f)(1)(ii)(D) be increased to $5,000, i.e., to the same level that applies to taxpayers with an AFS.

BACKGROUND

The final regulations on deduction and capitalization of expenditures related to tangible property, issued in 2013 (T.D. 9636, 78 F.R. 57686 (Sept. 13, 2013) (the "2013 Final Regulations")), set forth a *de minimis* safe harbor that, if satisfied, permits a taxpayer to treat an amount paid for the acquisition or production of a unit of tangible property as a currently deductible expense rather than a capital expenditure. The safe harbor, found in Treas. Reg. § 1.263(a)-1(f), distinguishes between taxpayers with an AFS and those without an AFS. Taxpayers with an AFS are eligible for the safe harbor if: (1) they have written accounting procedures that treat as an expense for non-tax purposes amounts paid for either property costing less than a specified dollar amount or property with an economic useful life of 12 months or less; (2) they treat the amount paid for the property as an expense on their AFS in accordance with the written accounting procedures, and (3) the amount paid for the property does not exceed $5,000 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance. In contrast, taxpayers without an AFS are eligible for the safe harbor if they meet the first two requirements listed above (with the second requirement applied with reference to the taxpayer's books and records for non-tax purposes) and the amount paid for the property does not exceed $500 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance.

The concept of a *de minimis* safe harbor was articulated in the preamble to the first set of proposed regulations on deduction and capitalization of expenditures related to tangible property (REG-168745-03, 71 F.R. 48590 (Aug. 21, 2006)) (the "2006 Proposed Regulations"). The second set of proposed regulations (REG-168745-03, 73 F.R. 12838 (Mar. 10, 2008)) (the "2008 Proposed Regulations") included a *de minimis* safe harbor for taxpayers with an AFS, as did the subsequently issued temporary regulations (T.D. 9564, 76 F.R. 81060 (Dec. 27, 2011) (the "2011 Temporary Regulations"). The 2013 Final Regulations extended the safe harbor to taxpayers without an AFS as described above.

[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code"), all references to "Treas. Reg. §" are to the Treasury Regulations promulgated thereunder, and all references to "Prop. Treas. Reg. §" are to Proposed Treasury Regulations.

DISCUSSION

In our opinion, none of the rationales advanced for a lower safe harbor limit for taxpayers without an AFS justify such a significant reduction in the limitation. The Service appears to have identified two such rationales for basing the safe harbor limit on whether the taxpayer has an AFS. First, taxpayers with an AFS are more likely to be larger businesses; therefore, an expenditure of $5,000 is less likely to be material and expensing such an item will more likely clearly reflect income. In its discussion of a *de minimis* rule that had been considered but not included, the preamble to the 2006 Proposed Regulations states: "Because taxpayers without an AFS generally are smaller than taxpayers with an AFS, the dollar threshold for the *de minimis* rule that would have applied to them would have been lower than the threshold for taxpayers with an AFS . . . ." Second, an audit subjects financial statements to independent review, which serves to validate the capitalization policy as clearly reflecting income. The preamble to the 2013 Final Regulations states: "The *de minimis* safe harbor for taxpayers without an applicable financial statement provides a reduced per invoice (or item) threshold because there is less assurance that the accounting procedures clearly reflect income." Although these rationales may arguably justify some reduction in the safe harbor limit for taxpayers without an AFS, we believe that the validity of these assumptions is questionable and that in any event the current 90 percent reduction in the limitation is excessive.

The thoughtful approach that Treasury and the Service have taken in developing the *de minimis* safe harbor over several years has reflected an attempt to balance two primary goals: reducing the administrative burden on taxpayers and ensuring clear reflection of income. For example, the 2008 Proposed Regulations and the 2011 Temporary Regulations defined the safe harbor limit not as a fixed dollar amount, but as percentages of the taxpayer's gross receipts or total depreciation and amortization expense. This limit was imposed—in addition to the requirement that the taxpayer treat the amounts in question as expenses on its financial statements—to ensure clear reflection of income. When commentators pointed out the administrative burden imposed by a limit expressed as a percentage of gross receipts or depreciation taken, Treasury and the Service expressed the limit as a fixed dollar amount in the 2013 Final Regulations.

The first rationale—an AFS as a proxy for taxpayer size, and thus the relative materiality of expenditures greater than $500—is inconsistent with today's business environment. Many large businesses may not have an AFS because they are not public companies subject to SEC requirements and can satisfy owners' and lenders' requirements with financial statements that are "compiled" or "reviewed" rather than audited. Thus, the distinction in the regulations may result in similarly situated taxpayers being treated differently. For example, if two businesses—one with an AFS and one without—have similar levels of gross receipts, depreciation, and total assets, the current regulations result in different treatment without adequate justification. Further, even for most small businesses, a $500 limit is well below the threshold of materiality at today's prices. The current $500 limit in the 2013 Final Regulations is too low to be of much use to taxpayers and does little to encourage taxpayers to purchase business assets. (By comparison, for 2014, taxpayers can deduct the cost of Section 179 property up to a limit of $500,000.) This has the effect of imposing a significant administrative burden on taxpayers with fewer administrative staff and thus least able to bear it. The Service might address this concern about materiality by use of a test that focuses on the taxpayer's asset size, gross receipts, or total depreciation and amortization, rather than the blunt proxy of whether the taxpayer has an AFS. Use of such factors is common for other purposes and, as long as the safe harbor limit itself is expressed as a fixed dollar amount, would not create the administrative difficulties cited in comments to the 2008 Proposed Regulations and the 2011 Temporary Regulations.

The second rationale—lack of the independent verification offered by an audit—is also not as persuasive as it may appear. Whether a given capitalization policy clearly reflects income for a particular taxpayer can be evaluated without the expensive undertaking of a full audit. For example, existing standards for a "review" of financial statements, and perhaps even a "compilation," will generally identify a capitalization level that is clearly inappropriate for that particular taxpayer. The Service might better address this concern about the taxpayer's use of a reasonable, consistent methodology by providing further guidance on the written accounting procedures that taxpayers must have in place and the manner in which taxpayers might demonstrate that they have adhered to those procedures.

We suggest that a reduction in the safe harbor limit, for taxpayers without an AFS, may not significantly enhance the likelihood that the tax return clearly reflects income but will significantly increase the administrative burden. Absent better information that more clearly supports a specific lower figure for taxpayers without an AFS, we recommend that the safe harbor limit in Treas. Reg. § 1.263(a)-1(f)(1)(ii)(D) be increased to $5,000, i.e., to the same level that applies to taxpayers with an AFS.