

State Bar of South Dakota
Tax Update XXXI
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**Important Developments in
Federal Income Taxation**

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Priming the Pump

- “A fool and his money are soon parted. It takes creative tax laws for the rest.”
 - United States v. Cohen (2009) (quoting Bob Thaves, author of the Frank and Ernest comic strip).
- “I don’t know if I can live on my income or not the government won’t let me try it.”
 - Another Bob Thaves classic.

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Organization

- Slides are selected from a more extensive written outline, which is available online.
- Outline is based on significant categories:
 - Gross Income
 - Deductions from Gross Income
 - Tax Liability
 - Payment, Collection, Litigation
 - Admin. Practice
 - Selected Partnership, Corporate Tax Issues
 - A few other topics, including legislative highlights
- Materials are selective, not comprehensive.
- Outline is updated through November 25, 2009.

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Gross Income: Timing

- Crop Insurance Proceeds, Nelson v. Commissioner, 568 F.3d 662 (8th Cir. 2009).
 - Taxpayers traditionally sold 65% of their sugar beets currently, 35% deferred to following year.
 - Their 2001 crop was destroyed and they collected \$200K in crop insurance proceeds in 2001.
 - They elected to defer 35% under section 451(d), but the Service taxed all \$200K in 2001.
 - Tax Court upholds IRS position, and 8th Circuit agrees.

Gross Income: Timing

- Case reflects conflicts between statute and IRS positions in regulations and a revenue ruling.
- Statute: permits deferral if “income from such crops would have been reported in the following taxable year” (How much? Any? All?).
- Regs: “**the** income ...” (All?)
- Rev. Rul. 74-145: “substantial portion”, which is defined as > 50% (What? Why 50%).

Gross Income: Timing

- Circuit finds IRS interpretation is reasonable: either “all” or “substantial” (i.e., > 50%) and defers accordingly.
- Is that consistent with the statute or other legislative intent to provide relief? If less than “all” is permitted, what makes 50% the magic threshold for “substantial”?
- Pending legislative relief, take note of the 50% restriction in this ruling and plan accordingly if clients have crop insurance and typically defer a portion of crop-related income.

Gross Income: Exclusions

- Longoria v. Commissioner, TC Memo 2009-162, is a textbook case for why lawyers handling claims for money need to consult tax lawyers early and often.
 - Taxpayer was a victim of racial discrimination. His claims included allegations of physical injuries related discriminatory treatment, including hazing by fellow officers.
 - Damages claimed here: “severe mental anguish; anxiety; stomach problems; sleep disorder; stress; diminution of the quality of his life and other hedonistic injury.” Note that physical injuries were not stated, but were raised orally in settlement negotiations.
 - Claims were settled for lump sum, and the settlement agreement did not allocate any proceeds to physical injury.

Gross Income: Exclusions

Some basic points here:

- Actual basis for the claim controls exclusion under § 104(a)(2).
- Taxpayer could not prove that settlement was based on personal physical injury as opposed to emotional distress claims.
- Despite return preparer’s failure to consult the actual complaint, taxpayer avoided penalty by using a professional (albeit not a very informed one on the matter of 104(a)(2)).

Gross Income: Exclusions

Some other exclusion items:

- “HAMP” program payments (from federal government to mortgage lenders for the benefit of those behind on mortgages) are excludable from income under general welfare provisions. Rev. Rul. 2009-19.
 - This ruling complements the amendment of section 108(a)(1)(E) exclusion for discharge of principal residence indebtedness.
 - Compare: Deferral allowed for COD income on business debt under section 108(i) (Rev. Proc. 2009-37).

Gross Income: Exclusions

- Does that employer-provided cell phone constitute an excludable working condition fringe? Not if you can't substantiate business usage! See Notice 2009-46.
- “[T]reatment of [cell phones as] listed property may have made sense years ago when the cost of a cell phone exceeded \$2,000 and the per-minute charges were about 50 cents, but ... [t]oday, based on cost and usage, cell phones are more akin to a land line phone which for years an employee may have occasionally used to make a personal call without tax consequences.” Prof. Annette Nellen, *Cell Phones and Our Outdated Tax Law* (at cpa2biz.com, 7/16/09).

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Gross Income: Deferral

- Retirement distributions generated litigation this year over the 10% penalty on early withdrawals.
- Dollander, T.C. Memo 2009-187, ruled that disability for purposes of federal employment is not sufficient to avoid penalty tax on IRA distribution.
 - Regulations define disability exception narrowly: unable to engage in any substantial gainful activity.
 - Disability also must be nonremediable (permanent).

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Gross Income: Deferral

- Benz, 132 T.C. No. 15, held that a young taxpayer who elects substantially equal periodic payments based on life expectancy does not incur penalty taxes by also choosing distributions for a child's college education expenses (§ 72(t)(2)(E)).
 - Additional education distributions did not constitute a prohibited modification.
 - More than one basis for penalty avoidance may thus be claimed by taxpayers in this context.

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Capital Gain or Ordinary Income?

- Muskat v. United States, 554 F.3d 183 (1st Cir. 2009) illustrates an unsuccessful attempt to recharacterize a noncompetition payment as capital gain from the sale of goodwill.
 - After paying taxes on payments as ordinary income based on a written allocation in connection with the sale of his company, taxpayer filed amended return seeking capital gain treatment.
 - Unfortunately for taxpayer, agreement stated that sums were to protect company's goodwill.

Capital Gain or Ordinary Income?

- Muskat faced a heavy burden (akin to “clear and convincing” evidence) to reform this agreement to fit his characterization of the transaction.
- Expert testimony as to the existence of personal goodwill was not admissible, as this case turned on the parties' intention.
 - The fact that payments would continue after taxpayer's death did not preclude ordinary treatment.
 - Case shows difficulty of changing a reporting position; counsel need to get it right at the outset (but that may not be what the parties wished to negotiate).

Capital Gain or Ordinary Income?

- Rice, T.C. Memo 2009-142, ruled that a sale of lots from land acquired to build a “dream home” generated capital gain, not ordinary income.
 - Rice bought 14.4 acres on which to build home. Wife later wished to have neighbors, so they put up a sign. Sales occurred over time to friends, relatives, etc.
 - Were these held primarily for sale to customers in the ordinary course of business? No!

Capital Gain or Ordinary Income?

Factors considered included:

- Substantiality and frequency of sales favored capital gain treatment.
- Improvements on the land were for taxpayer's own home, and not only for the benefit of the lots being sold.
- Taxpayer had other income; did not reinvest proceeds in more real estate.
- Consult this case for a helpful discussion of relevant facts in this situation.

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Surrender of Life Insurance Policy

- Barr, T.C. Memo 2009-250, ruled that a taxpayer who surrendered a life insurance policy, receiving less than \$12K in cash, nevertheless had ordinary income of more than \$135K measured by the excess of loans over the investment in the policy.
- The policy was gifted from his mother.
- All loans were used to pay premiums on the policy. Neither taxpayer nor his mother got any personal benefit (other than insurance coverage).
- Is the law being an "ass" here?

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Deductions!

- "If you are truly serious about preparing your child for the future, don't teach him to subtract – teach him to deduct." - Fran Lebowitz
- Some of the deduction issues presented this year arise from stimulus or related legislation:
 - Revenue Procedures 2009-26 and 2009-52 (forthcoming) provide guidance for taxpayers eligible for expanded NOL carryback periods. New legislation expands this option (see below).
 - Notice 2009-38 addresses problem of section 382 issues affecting loss corporations.
 - This time we have Congressional authorization.
 - Cf. Notice 2008-83, later revoked by Congress in Pub. L. 111-5, which unilaterally provided relief for bank takeovers in the height of the financial crisis.

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Charitable Deductions

- Tuition payments to Day School are not charitable contributions, Sklar, 549 F.3d 1252 (9th Cir. 2008).
 - Problem: Taxpayers could not show they were making a gift instead of engaging in quid pro quo.
 - A study showing that their Orthodox Jewish school cost more than area Catholic schools was rejected; it did not show market value due to parish subsidies.
 - Perhaps the most interesting argument was rooted in administrative consistency based on settlement in Scientology cases. (See below)

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Charitable Deductions

- Scientologists may have gotten a good deal in their closing agreement, but that did not help the taxpayer here, when a similar deal would require rewriting the Tax Code and the Establishment clause.
- Administrative consistency is apparently a thin reed on which to base a successful argument for relief.
- This illustrates the need to ensure the IRS is free from political influences in settlements.

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Charitable Deductions

- \$29 million conservation easement deduction upheld, Kiva Dunes, T.C. Memo 2009-145.
 - Case is a good illustration of the battle of experts in valuation controversies.
 - Taxpayer victory is nearly complete, with IRS arguing no deduction, IRS expert allowing \$10 million, and court giving Taxpayer \$28 million (vs. 30 million claimed).

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Charitable Deductions

- Discovery papers do not generate charitable deduction, *Jones v. Commissioner*, 560 F.3d 1196 (10th Cir. 2009).
 - Jones defended Timothy McVeigh in the Oklahoma City bombing case. He sought to deduct the appraised value of \$294K for legal papers he acquired.
 - Tax court disallows on two grounds: no property interest in this material under OK law; deduction limited to his basis as property was not a capital asset.
 - 10th Cir affirms on basis of 1221(a)(3)(B): letter, memo “prepared or produced” for taxpayer is not a capital asset; he could not prove basis; no deduction for you!

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Business Expenses

- Doing the “bump” does not generate traveling expenses deduction, *Wilbert v. Commissioner*, 553 F3d 54 (7th Cir. 2009).
 - Airline mechanic used “bumping” rights to displace junior employees at other maintenance sites during period of layoffs.
 - As he moved to those sites, he incurred duplicate living expenses from his MN home, where his wife lived.
 - 7th Cir. Rejected approach of tax court, which relied upon “temporary” (deductible) vs. indefinite (not deductible) as unworkable.

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Business Expenses

More on Wilbert:

- Court rejected “personal choice vs. reasonable response to employment” test as unworkable. After all, personal factors like quality of schools, friendships, etc. could be reasonable, too.
- Test applied: did business exigencies cause this move? With no firm expectation of being restored to his MN post soon, he was deemed similar to a construction worker going to different work sites, rather than a lawyer trying cases in different cities away from the home office.
- Examples and discussion are useful for analyzing similar problems for mobile employees.

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Reasonable Compensation

- Menard, Inc., 560 F.3d 620 (7th Cir. 2009), provides another blistering decision upholding deduction of a \$17 million bonus to the CEO of the popular home improvement store.
 - Judge Posner, following Exacto Spring, reiterated criticism of multifactor tests. Investors here prospered under Menard.
 - “Clawback” agreement, requiring CEO to reimburse corporation for adverse tax ruling, was not determinative – they were needed because of the uncertainty the tax court creates with its multifactor tests applied in reasonable compensation cases.

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Reasonable Compensation

More on Menard, Inc.:

- Failure to hire a compensation consultant to evaluate this package was not determinative: “Menard doubtless has a strong opinion of what he is worth to his company and would not pay a compensation consultant to disagree.”
- Nor was the fact that Menard was also majority shareholder (and sole voting shareholder) – “bonuses do not only, or even primarily reward motivation; they reward performance.”
- An important taxpayer victory, despite continuing skepticism about the independent investor approach favored by the 7th Circuit.

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Business Expense: Not!

- \$113 million deduction denied under origin-of-claim doctrine, Wellpoint, T.C. Memo 2008-236
 - Wellpoint incurred over \$800K in legal fees in lawsuits from state AGs seeking to impose a constructive trust on corporate assets when it converted from a nonprofit to for-profit corporation.
 - It settled by making payments of \$113 million.
 - Wellpoint deducted the payments and fees on the basis that it was avoiding business disruptions and a loss of goodwill. (Sounds good, right?)

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Business Expense: Not!

More on Wellpoint:

- But the claims here originated from a challenge to Wellpoint's title to its property. Defense of title is a classic capital expenditure.
- Unlike deductible payments to defend against a hostile takeover in *AE Staley* (7th Cir. 1997), these expenses had significant future benefits to the company. (So, this is where the disruption comes in!)
- Wellpoint's argument proves too much, as nearly all settlements prevent business disruption, no?

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Business Expense: Not!

- Preopening Expense doctrine barred deductions in *Woody*, T.C. Memo 2009-93.
 - *Woody* exemplifies the timing distinction inherent in IRC § 195, which requires capitalization and amortization instead of current deduction when a taxpayer enters a new trade or business.
 - *Woody* wanted to be in the real estate rental business, but he failed to buy a property until 12/30, and even then he failed to offer it for rent.

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Business Expense: Not!

Woody, continued:

- The largest of *Woody's* expenditures – a training program for real estate – was nondeductible because it prepared him for a new trade or business. See *Treas. Reg. 1.162-5*
- The date on which business commences is a critical date for measuring when section 162 begins and section 195 ends.
- This taxpayer was actively learning the business and seeking out property to purchase, but he could not show that he began a real estate rental business.
- Note how this means that a taxable year is effectively divisible for purposes of evaluating deductible expenses.

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Business Expenses: Settlement

- Gralia, T.C. Memo 2009-219, involved the tax treatment of a \$600K settlement paid by a shareholder/director in connection with a claim by a former shareholder that he breached a fiduciary obligation.
- Gralia was allowed to deduct the settlement only as a miscellaneous itemized deduction, which was not helpful for AMT purposes.
- Critical to Gralia's loss was the inability to prove that he paid this in any capacity except that of an employee-director. (Cont'd)

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Business Expenses: Settlement

- Even receiving it as a shareholder would not help, as this is still a misc. itemized deduction.
- Gralia was also a real estate developer, but he could not prove that the fiduciary claim against him was rooted in that activity.
- Apparently, Gralia was not able to prove that being a director was a trade or business other than an employee.
- Query whether regular director fees might change that result?

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Passive Activity Limitations

- Senra, T.C. Memo 2009-79, illustrates the pitfalls of owning real estate in a separate entity from an operating company that conducts an active business.
 - Taxpayers had wage income from their operating company, a granite retailer.
 - They also owned a warehouse through a single-member LLC.
 - Their operating company rents the warehouse from the LLC, which due to depreciation and related expenses, generates net losses for taxpayers.

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Passive Activity Limitations

Senra, continued:

- IRS disallows the losses, which were reported on Schedule C, under passive activity restrictions (§ 469).
 - The LLC was only engaged in rental activity, with no other active business.
 - Neither taxpayer was a qualified real estate professional.
 - Passive losses from renting real estate could not be grouped with their active business conducted through the operating company.
 - Taxpayers might have held the warehouse in their operating company without triggering the 469 limitation – but taxpayer is stuck with the form he chooses.
 - Of course, economic tradeoffs lurk here, too, when considering the locus of ownership for the building.

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Other deductions: Theft Losses

- Vincentini, T.C. Memo 2008-271, deals with the deduction claim for theft by an investor defrauded in a tax shelter scheme.
 - Taxpayer paid \$76,500 in fees in 1999 associated with a phony loan through one of the promoter's related entities. The loans did not, in fact, exist. He also lost more than \$500K in other funds.
 - Promoters were arrested in 2001, and thereafter followed various convictions. In 2005, the court ordered restitution to investors in the scheme.
 - Taxpayer conceded the substance of the shelter related deductions (what else could he do?), but sought to characterized the fees as a theft loss in 2001, the year he allegedly discovered the theft.

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Other deductions: Theft Losses

Vincentini, cont'd:

- Taxpayer apparently wanted to offset the large disallowed deduction from the shelter in 1999, which was intended to offset the \$800K premature distribution from an IRA. (Doh!)
- The IRS was estopped from denying that a theft occurred based on the conviction of the promoters in this other federal case.
- However, taxpayer could not prove a reasonable certainty of no recovery in 2001. The deduction was still disallowed.

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Other deductions: Theft!

Vincentini, cont'd:

- Taxpayer suffered an accuracy penalty, since he could not prove reasonable cause. Self-serving testimony about consulting a professional (which was disregarded), coupled with reliance upon a promoter for advice, does not suffice.
- Though the discovery rule is taxpayer friendly (in that it prevents a statute of limitations bar in many cases), the result here was not helpful. (With income from the IRA as the basis for the shelter, would this taxpayer be able to use a future loss?)
- Compare Wyatt, TC Memo 2008-253, for another sad taxpayer tale involving a theft loss claim.

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Alimony

- Sperling, T.C. Memo 2009-141, illustrates the need for tax advice in drafting divorce settlements and preparing tax returns based on them.
 - Taxpayer sought to deduct a payment toward the purchase of a condominium for his former spouse as alimony. (After all, the divorce decree ordered the payment.)
 - The problem was, the divorce decree references a property settlement agreement, which makes this obligation survive the death of his ex-spouse. This violates § 71(b)(1)(D).
 - This pro se taxpayer loses.

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Other Deductions

- Divorce related problem of dependent exemptions: CCA 20095041 (5/11/09) advises that noncustodial parent must now use Form 8332, rather than appending court documents, to substantiate claims. (Court documents are admittedly difficult to interpret.)
- After an IRS change of heart, those "convenience fees" incurred to pay taxes by credit/debit card are now eligible to be treated as a misc. itemized deduction (IR 2009-37).

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Other Deductions

- Melvin, TC Memo 2009-199, involved the tax consequences of credit card debt reduction
- Debt relief was COD income here; not a disputed debt amount. (Compare McCormick, TC Memo 2009-239, where a dispute prevented COD income)
- Payment to debt reduction firm was eligible for a § 212(1) deduction, but note this will not help those (like Melvin) who are subject to AMT.

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Other Deductions

- LaPlant, T.C. Memo 2009-226, is a sad story about a widow trying to substantiate gambling losses from extensive slot machine play.
 - Significantly, the Service conceded she could measure gambling income based on net wins or losses per visit (or more particularly, per cash-out).
 - This is taxpayer friendly, as otherwise all wins are in AGI and all losses are deductible only as itemized deduction.
 - Practically speaking, how can taxpayers keep track of this detail?
 - Note adverse tax effects from higher AGI (including SS benefit taxability).
 - Here “player club” information was not sufficient to substantiate losses where it was not specific as to each day she played.

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Credits: Homebuyers

- Guidance for first-time home buyers IRO-2009-27 provides filing options for the \$8K credit. (And there was an extension/expansion – see the legislation slides below).
- Notice 2009-12, 2009-6 IRB 446, addresses topic of allocating credit between unmarried co-purchasers, generally adopting a pro rata approach for determining the eligible cost attributed to each co-owner.
- INFO 2009-0131 clarifies that if H and W buy their first home from H’s parents, W is still eligible for her share of the credit. (See IRC § 36(c)(3)(A)).

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Credits: Homebuyers

- TIGTA ,‘The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit,’ Oct. 22, 2009, House Ways and Means Oversight Subcommittee Hearing on Home Buyer Tax Credit
 - Failure to verify eligibility requirements
 - Failure to provide documentation to substantiate home purchase (\$139 million in credits)
 - November 2009 legislation addresses these problems (see below).

More Credits

- Notice 2009-37 notes that Ford has finally begun to phase out its eligibility for lean burn and hybrid vehicle credits, effective April 1.
 - 50% through 9/30/09; 25% through 3/31/10
 - Toyota and Honda hit these limits in prior years.
 - RIA says: “several years before [GM or Nissan] reaches 60,000 hybrid vehicle sales.”
- Notices 2009-41, -53, home energy credits guidance (green is good, and rewarding, too).

Levy and Collection

- **The Government may levy on your HSA and impose an additional 10% tax on the withdrawal! CCA 200927019 (July 2, 2009).**
 - Section 223(f), which governs the HSA, does not contain an exemption to the ten percent penalty for an IRS levy.
 - Perhaps a future amendment will be required to conform HSA treatment to that of IRAs under section 72(t).
 - Despite hardship, IRS is following the law.

Levy and collection

- The right to renew season tickets is probably not a property right subject to levy if team limits transferability, NDSAR 2102F (May 22, 2009).
 - Chief counsel advised the field that, where rights are not transferable, these are probably not subject to levy. Thus, IRS limited to return of deposit.
 - Elsewhere, should we look for sports tickets at government auctions?

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Offers in compromise

- O'Neil, T.C. Memo 2009-183, reminds us that there is no OIC unless you pay 20% down, a \$150 filing fee, and submit a claim on Form 656.
 - Without this, there is no claim to consider or to challenge in a collection due process proceeding.
 - Administrative negotiations bind no one.

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Offers in compromise

- Keller, 568 F.3d 710 (9th Cir. 2009), illustrates broad IRS discretion for offers in compromise.
 - “A compromise to promote effective tax administration based on public policy or equity considerations will be justified only where, due to exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner.”
 - Here, tax shelter victims were defrauded, and case took 20 years to resolve, but that was not a sufficient basis to compel the IRS to grant relief.
 - “[R]educing the risks of participating in tax shelters would encourage more taxpayers to run those risks.”

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Petitions for Refund

- Muskat v. United States, 554 F.3d 183 (1st Cir. 2009), reinforces the need to make administrative claims for refund before trial.
- “A taxpayer is the master of his refund claim, and it is not the IRS’s responsibility to make a case for the taxpayer that the taxpayer himself has opted not to make.”

Attorney Fees (§ 7430)

- Section 7430 generally permits a prevailing taxpayer to recover attorneys fees if the government’s position was not substantially justified. A net worth limitation also applies.
- An appeals conference is essential, even when IRS concedes at trial. Brunzell, T.C. Memo 2008-248.
- The Commissioner’s position may be incorrect but nevertheless be substantially justified “if a reasonable person could think it correct.” Swanson, T.C. Memo 2009-170.
 - Facts and circumstances known at the time the Service established its position are relevant.
- Fact-based disputes, such as the education exception for medical residents, are a difficult context to recover attorney fees. Center for Family Medicine (D. S.D. 2009)
- See new proposed regulations (REG-111833-99, 11/25/09) on attorney fees and administration costs.

Attorney Fees (§ 7430)

- Morrison, 565 F.3d 658 (9th Cir. 2009), allowed recovery of attorney fees even though the taxpayer did not incur them in advance.
 - Here, “reasonable fees paid or incurred” in section 7430 were held to include fees paid by corporation on behalf of shareholder where a non-contingent obligation to repay or a contingent obligation arises upon their recovery.
 - Those drafting fee agreements should take note of this case.
 - Surely this is the right policy result: IRS should not profit from serendipity.

Attorney Fees – cont'd

- Dixon, 132 T.C. No. 5 (2009), held that attorney fees imposed on the government under IRC § 6673 for multiplying proceedings “unreasonably or vexatiously” or awarded under general equitable powers may be allowed even for pro bono or reduced fee cases.
 - A sanction is not limited to prior agreements between taxpayer and counsel.
 - Court has inherent powers to award fees in cases involving abuse of process, which here involved government attorneys.

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Innocent Spouse

- The equitable claim for relief in § 6015(f) contains no limitation period; innocent spouse relief may be pursued despite the 2 year limitation imposed on other claims. Lantz, 132 T.C. No. 8 (2009).
 - Husband was dentist convicted of Medicare fraud, who ultimately died in federal custody after collection actions had begun.
 - Wife relied upon husband’s assurance that he was taking care of collection issues.
 - Reg. 1.6015-5(b)(1), imposing a 2-year limitation period, was declared in conflict with statute.
 - Divided tax court ruling means potential uncertainty.

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Innocent Spouse

- Porter v. Commissioner, 132 T.C. No. 11 (2009), rules that the Tax Court will review administrative denial of equitable relief on *de novo* basis.
 - This means facts not presented at administrative hearing may be presented at trial (but why limit your chances at relief?).
 - Divided court also approved equitable relief here.
 - Chief Counsel advice suggests IRS opposes *de novo* review, as well as statute of limitation ruling in Lantz, but IRS is reviewing cases for relief in light of these taxpayer-friendly results.

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Innocent Spouse

- Johnson, T.C. Memo 2009-156, suggests that innocent spouse should testify as to whether she has “reason to know of the understatement”, as court invokes negative inference against the spouse when she fails to do so.
 - Taxpayer here also remained married and benefitted from the excluded income coming from an IRA distribution.
 - But note: spouse was ill, and the benefit came from a car to take her to medical appointments.
 - Equitable scales do not always balance so clearly in these kinds of disputes.

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Taxpayer Assistance Orders

- REG-1552166-05 (July 27, 2009), provides proposed rules governing Taxpayer Assistance Orders (TAOs).
 - Section 7811 authorizes the National Taxpayer Advocate to intervene by issuing a TAO to provide relief for a taxpayer from a “significant hardship” suffered from the administration of tax laws.
 - This kind of discretionary relief may provide another avenue besides litigation to constrain vexatious behavior, but don’t count on it.

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Small Tax Cases: A Hidden Risk?

- Mitchell, 131 T.C. No. 15 (2008), involves what seems to be settled law concerning QDROs, but the real issue is whether a Tax Court Summary Opinion has preclusive effect.
- Taxpayers are left with uncertainty as to whether a small tax case disposition in a prior year has preclusive effects.
 - Small tax cases are unreviewable. Perhaps a taxpayer does not fully litigate the matter due to cost, etc.
 - But judicial economy may be ill served when the same issue is presented again for a different tax year.
 - Note that either the IRS or the Taxpayer might be affected adversely.

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The Penalty Box

- *Boggs*, 569 F.3d 235 (6th Cir. 2009) upholds the imposition of \$18,000 in total penalties (\$10,000 by the Tax Court, \$8,000 on appeal) for a taxpayer arguing wages were not taxable because they were a return on human capital (i.e., a recovery of the loss of human life).
 - IRS noted that average cost of defending frivolous appeals is \$11,000.
 - Cf. *Phillips*, T.C. Memo 2008-8, where naïve taxpayer avoided similar penalties.

The Penalty Box

- *Clearmeadow Investments*, 87 Fed. Cl. 509 (2009), prevented a partnership from raising the matter of the “reasonable cause” exception to the gross valuation misstatement penalty” in section 6664(c).
 - *Clearmeadow* says only a partner can raise this defense.
 - Other courts disagree, including *Klamath Strategic Investment Fund*, 568 F.3d 537 (5th Cir. 2009), and *Stobie Creek Investments*, 82 Fed. Cl. 636 (2008).
 - *American Boat*, 583 F.3d 471 (7th Cir. 2009) also rejected *Clearmeadow*’s approach.

Clearmeadow, cont’d

- *Clearmeadow Investments*, 87 Fed. Cl. 509 (2009), also ruled that a “substantial valuation overstatement” occurred when the valuation differential occurred due to the application of economic substance doctrine.
 - Fifth and Ninth Circuits disagree.
 - Second, Third, Fourth, Sixth, and Eighth, plus the Tax Court, agree with this outcome.

Clearmeadow, cont'd

- Court was concerned about gamesmanship: “in the last instance-perhaps in the face of a motion or on the eve of trial-to concede the resulting deficiency on economic substance grounds and thereby avoid the imposition of the penalty.”
- “Creating such a convenient escape hatch would not only defeat the very purpose of the penalty, which is to discourage taxpayers from filing returns that rely upon overstated bases, but, in fact, transmogrify the penalty into one imposed only upon ill-advised litigants.”

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The Penalty Box – cont'd

- The “reasonable cause” exception depends on whether a taxpayer gets advice from a competent, independent professional.
 - Tax advice from a shelter promoter and related advisors doesn't count. Snyder, T.C. Memo 2009-97 (and it doesn't help to be a tax professional who should know better)
 - Naïve taxpayers (white hat, but cone-shaped) may be more likely to get relief. See Swanson, T.C. Memo 2009-31, for a useful listing of cases.
 - See also American Boat, 583 F.3d 471, with a taxpayer-friendly result on the “reasonable cause” defense involving a lawyer who also represented the promoter.

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Administrative Practice

- Notice 2006-50 may violate the APA, United States v. Cohen (D.C. Cir. 2009).
 - An odd case, in that the taxpayer was only challenging the process for refunds prescribed by Notice 2006-50.
 - DC Circuit found that it had federal question jurisdiction to consider this question, and it concluded that the issue of whether the Notice constituted final agency action in violation of the Administrative Procedure Act was triable.
 - Case is full of rebukes to the government, including calling its position “just plain mean”.
 - Ultimate impact is uncertain, but perhaps more Notices and procedures will be challenged under APA grounds if this is successful.

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Return Preparers, Take Notice:

- Notice 2009-13 limits disclosures of return information for marketing purposes:
 - Prohibits disclosure of “average refund, credit, or rebate amounts, or a part thereof for purposes of advertising or marketing.”
 - Allows anonymous statistical compilations of return information (if from greater than 25 returns) in support of business.
 - Prohibits sale of taxpayer data, except in connection with sale of return preparation business.

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Return Preparers, Take Notice:

- Final regulations for criminal penalties with regard to unauthorized disclosures. Treas. Reg. § 301.7216-1 (1/1/09).
 - Knowingly or recklessly disclosing without client consent can yield up to one year imprisonment and a fine of up to \$1000.
 - Civil penalties may also apply. See IRC § 6713
- E-filing now required for those filing 10 or more returns – See Pub. L. No 111-92 (11/6/09)

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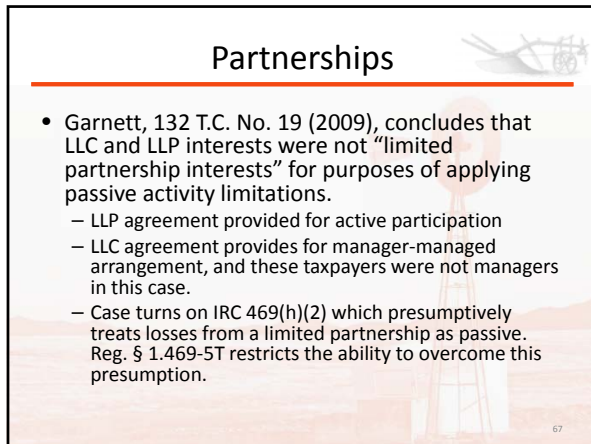
Return Preparers, Take Notice:

- E-file providers are now subject to new data security and privacy standards, see Announcement 2009-56.
 - Website must be with U.S. registrar (presumably to facilitate legal remedies for breach).
 - Data breaches must be reported and site must cease collecting taxpayer information until breach causes are resolved.
 - IRS will list compliant vendors who are eligible to run required “external network vulnerability scans” consistent with standards for the payment card industry (PCIDSS).
 - Those who use another host must ensure that hosting party is compliant. (How?)
 - Note the “knowingly or recklessly” disclosing penalty, above.

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Partnerships

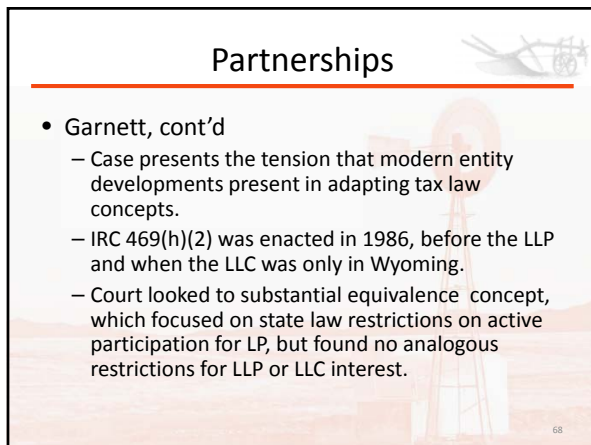
- Garnett, 132 T.C. No. 19 (2009), concludes that LLC and LLP interests were not “limited partnership interests” for purposes of applying passive activity limitations.
 - LLP agreement provided for active participation
 - LLC agreement provides for manager-managed arrangement, and these taxpayers were not managers in this case.
 - Case turns on IRC 469(h)(2) which presumptively treats losses from a limited partnership as passive. Reg. § 1.469-5T restricts the ability to overcome this presumption.



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Partnerships

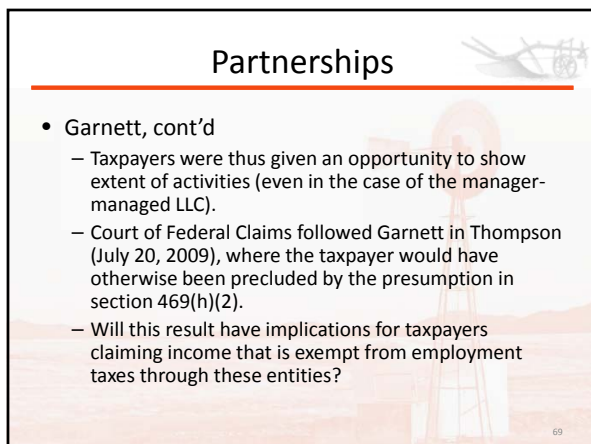
- Garnett, cont’d
 - Case presents the tension that modern entity developments present in adapting tax law concepts.
 - IRC 469(h)(2) was enacted in 1986, before the LLP and when the LLC was only in Wyoming.
 - Court looked to substantial equivalence concept, which focused on state law restrictions on active participation for LP, but found no analogous restrictions for LLP or LLC interest.



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Partnerships

- Garnett, cont’d
 - Taxpayers were thus given an opportunity to show extent of activities (even in the case of the manager-managed LLC).
 - Court of Federal Claims followed Garnett in Thompson (July 20, 2009), where the taxpayer would have otherwise been precluded by the presumption in section 469(h)(2).
 - Will this result have implications for taxpayers claiming income that is exempt from employment taxes through these entities?



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Partnerships

- Curr-Spec Partners, LP v. Commissioner (5th Cir. 2009), concludes that a FPAA can be issued at any time, but it will only affect partners whose return years are still open.
 - I.R.C. § 6229(a) provides no maximum limitations period for issuing an FPAA for a partnership.
 - This allows assessments against some partners, but not those with closed tax years, but that is a problem for Congress.
 - Example: FPAA issued in 2004, 4 years after partnership filed its 1999 tax return. Partner A timely filed her 1999 tax return in 2000 and is protected by 3-year statute of limitations; Partner B carried forward a loss from 1999 to 2000, reflected on her return filed in 2001. B may be affected by the partnership adjustment.
 - Tax Court, D.C., and Federal Circuits agree on this point.

LLC Converting to S Corporation

- Rev. Rul. 2009-15 clarifies that an LLC taxed as a partnership that “checks the box” to be taxed as an association is allowed to make an S election for the first taxable year as a corporation.
- The metaphysics of conversion help explain this result, and ensure that a C corporation with a short taxable year is not created (see below).

LLC Converting to S Corporation

- Metaphysics (Treas. Reg. 301.7701-3(g)(3)(i)):
 - LLC assets are contributed to Corporation.
 - Corporation distributes its stock to partners.
 - This all occurs before the close of the date when the election is effective.
 - So, for example, if the election is made on 12/31/09, the corporation’s new taxable year will begin on 1/1/10 (thus preventing a short taxable year problem).
 - Assuming a timely S election, the above events show no ineligible shareholders for the taxable year.

Roth IRA Ineligible Shareholder

- **Roth IRA is not an eligible S corporation shareholder, Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. No. 9 (2009).**
 - Despite the fact that neither statute nor regulations proscribed an IRA as an ineligible shareholder, the Tax Court majority ruled that it was ineligible.
 - Five dissenting judges disagreed.

Tax Evasion Conviction for C Corp. Distributions: Boulware

- United States v. Boulware, 558 F.3d 971 (9th Cir. 2009), takes up where the Supreme Court left off with regard to a shareholder convicted of tax evasion for funds distributed from his corporation and unreported on his personal taxes.
- Boulware sought to present a defense that these distributions were made with respect to stock, and that the corporation had no E&P.
- At issue before the 9th Circuit was whether Boulware deserved a new trial to present the return of capital defense. It held he did not.

Tax Evasion Conviction for C Corp. Distributions: Boulware

- Showing an intent to make a distribution with respect to stock was not required.
- However, Boulware failed to establish that he could not have received these payments in a capacity other than as a stockholder. (How would one show that it was only a distribution with respect to stock without corporate minutes, etc., which are lacking in cases in which a sole shareholder takes corporate funds for personal use?).
- Moreover, Boulware also failed to show that he had a basis in excess of the \$10 million he distributed from the corporation, which would be essential to avoiding tax consequences on the distribution, even without E&P.

Tax Shelters: Privilege Issues

- **Textron (1st Cir. 2009)**, ruled that tax accrual workpapers were not protected from IRS summons based on the work product doctrine.
 - Majority viewed work product in a functional sense, limited to protecting work done for litigation, not in preparing financial statements.
 - Taxpayer had to prepare these workpapers to support financial statements, as required by securities laws and audit requirements.
 - Allowing access here also helped IRS to detect and disallow abusive tax shelters.

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Tax Shelters: Privilege Issues

- **Textron, cont'd**
 - Vigorous dissent objected, and particularly criticized the circumvention of FRCP 26(b)(3) protection for work product “in anticipation of litigation or trial”.
 - Policy implications also weight against disclosure, including threat to accuracy of disclosure to auditors.
 - Look for further litigation on this topic. The narrowing of work product protection raises troublesome implications for taxpayers. Can we depend on self-restraint in this area, with the IRS asking only for such documents when tax shelters are involved?

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Tax Shelters: §7525 Privilege

- **Countryside Ltd. Partnership, 132 T.C. No. 17**, ruled that notes from a telephone conversation with the client’s CPA were protected by the privilege under § 7525.
 - Notes were not a “written communication”, but were only a holographic record of discussion points.
 - CPA here prepared returns and gave advice for many tax matters, and did not cross the line from “trusted adviser to promoter” of the tax shelter.

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Tax Shelters: §7525 Privilege

- Valero Energy, 569 F.3d 626 (7th Cir. 2009), reaches the opposite conclusion of the Tax Court with regard to a CPA privilege.
 - IRS sought documents from Arthur Anderson, including worksheets with financial data and estimates of tax liabilities, which were gathered to facilitate filing tax returns. This was deemed accounting advice, which was open to the government.
 - As for the tax shelter exception, the 7th circuit found that merely furtherance or encouragement was sufficient to find “promotion”, notwithstanding the longstanding client relationship here.

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Tax Shelters: §7525 Privilege

- Valero, cont’d.
 - Valero’s argument that the tax shelter exception would swallow the scope of the privilege, if applied to any advice that furthered or encouraged participation as “promotion”, seems to be a fair point. But the 7th Circuit was not convinced.
 - Note that this approach differs substantially from the scope of “promotion” contemplated by the Tax Court in Countryside, above.
 - Look for this issue to emerge in further litigation.

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Tax Shelters: Administrative Summons

- Bernhoft (E.D. Wis. 10/28/09), 2009 WL 3451102, would not quash an administrative summons for communications and all documents involving an independent contractor suspected of peddling abusive tax shelters.
- Generalized, blanked claims of privilege in client-related documents were not sufficient.
- Bad behavior by individual IRS agents was not a basis for showing institutional bad faith.

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Tax Shelters: Bank Secrecy

- The Government's decision to dismiss the summons enforcement case against Swiss firm UBS, based on a settlement announced in September, reflects a potentially important development in the war against untaxed income sheltered in foreign bank accounts.
- A brief summary of key principles may prove helpful to put this matter in context.

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Tax Shelters: Bank Secrecy

- Taxpayers with foreign bank accounts must disclose on Form 1040, Schedule B, Part III
 - Yes or no: A binary result.
 - Some with bank accounts may be eligible to check no, as in cases where funds are \$10K or less.
 - If you check yes (or should have checked yes), the taxpayer is required to file an FBAR (Treasury Form TD F 90-22.1) by June 30. (For clients with foreign bank accounts, this date may be even more significant than April 15.)

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Tax Shelters: Bank Secrecy

- Not filing an FBAR is a big deal.
 - Separate offense for each failure to file, with five year statute of limitations. See 18 U.S.C. § 3282.
 - Civil penalties are stiff, up to \$100K per account or half the balance in the account, whichever is greater, for willful violations.
 - Such penalties are nondischargeable in bankruptcy. See *United States v. Simonelli*, 614 F.Supp.2d 241 (D. Conn. 2008).
 - Criminal penalties may also apply.
 - Multi-year + multi-account = big \$ costs.

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Tax Shelters: Bank Secrecy

- A voluntary disclosure program, with reduced penalties, expired 10/15/2009 (extended from 9/23/09).
- UBS and the Swiss government are allowed to choose whose accounts are disclosed pursuant to a bilateral tax treaty. Those account holders will be told before the U.S. government, allowing time for "voluntary" compliance under the disclosure program.
- Note that many foreign accounts exist. UBS is but one institution in Switzerland. Others exist across the globe.
- Liechtenstein has recently approved a Tax Information Exchange Agreement with the U.S., suggesting greater cooperation from this former haven.

Tax Shelters: Bank Secrecy

- The U.S. is considered a tax haven for wealthy Mexican citizens due to its banking laws. Are we being hypocritical for demanding disclosures from others?
- In UBS alone, over 4000 accounts were requested. Only a portion will probably be disclosed. How will the IRS deal with this enforcement issue? As of 11/17, about 14,700 have come forward with disclosures.
- Remember the cardinal rule of tax practice: "If someone has to go to jail, make sure it is the client." (Bank executives might consider adding that to the curriculum in banking school, too.)

Foreign Bank Account's (cont'd)

- Another important issue for those representing executors – what fiduciary obligations do they have to report and address foreign bank accounts disclosed in the administration of an estate? *See Kapiloff & Bracknet, Stuck with the Bill? An Executor's Personal Liability for Unreported Foreign Accounts, 111 J. Tax'n 168 (Sept. 2009).*

Economic Substance

- Economic substance, in its varying forms, has proven to be an important weapon in the arsenal employed against tax shelters.
- Cases in this area are fact intensive and complex. The outline online discusses several in detail.
- Below is a summary of some key issues decided in the past year.

Economic Substance

- “A lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance.” *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009).
 - Fifth Circuit follows emerging majority view on this point, in contrast to Fourth Circuit which stands alone in finding that a lack of economic substance also requires a showing that the taxpayer’s sole motive is tax avoidance.
 - The majority approach is much easier for the government; the Fourth Circuit approach gives more protection to taxpayers.

Economic Substance

- A remote possibility of profit, in a situation where the taxpayer would not ordinarily recoup the fees and expenses incurred to plan a transaction, will not shelter the transaction from an economic substance challenge. See *New Phoenix Sunrise Corp.*, 132 T.C. No. 9 (2009) (Following Sixth Circuit law).

Economic Substance

- Deductibility of fees and costs present a continuing challenge for taxpayers.
 - *Klamath, supra*, denied interest deductions with regard to loans that lacked economic substance.
 - As for other fees, deductibility under section 212 depended on whether incurred in pursuit of profit (which could be tough where only tax savings are sought).

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Economic Substance

- Valuation penalties may apply to overstated basis that is reduced through application of economic substance, though this is not settled.
 - *New Phoenix, supra*, so held.

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Economic Substance

- Uncertainties persist in the matter of retroactive application and/or validity of Treas. Reg. 1.752-6 with regard to contingent liabilities.
 - Murfam Farms (Fed. Cl. 2009) ruled that these regulations were invalid as exceeding Congress' mandate in § 309(a) in year 2000 tax legislation.
 - Other district courts have similarly disallowed the application of these regulations to prior transactions.
 - But the 7th Circuit (*Cemco Investors*) and a California district court come out differently.
 - The Federal Circuit in *Marriott Int'l Resorts* (10/28/09) finds authority to address short sale liability predates the regulations, going back to enactment of section 752 in 1954 Code.

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Statute of Limitations for Tax Shelters

- Does an overstated basis, deflated through economic substance, permit the IRS to invoke the 6-year statute of limitations for a substantial omission of income?
 - 9th Circuit: No (*Bakersfield Energy Partners, LP*).
 - Fed. Circuit: No (*Salman Ranch*).
 - UTAM, Ltd., TC Memo 2009-253 (No – following DC Circuit)
 - But compare *Highwood Partners*, 133 T.C. No. 1 (2009), where 6-year statute of limitations invoked when taxpayer failed to adequately disclose gains and losses, choosing to disclose net loss only.
 - TD 9466 (effective 9/24/09) is a “fighting regulation” designed to change the outcome in the government’s favor.

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FICA/Withholding Issues

- Rev. Rul. 2009-11 provides that differential pay for employees in military service is subject to income tax withholding, but not FICA or FUTA. (This applies to payments after 12/31/08).
- If at first you don’t win, promulgate new regulations! *Mayo Foundation v. United States*, 568 F.3d 675 (8th Cir. 2009).
 - An IRS victory on medical resident employment taxes based on Chevron deference to regulations adopted in 2005 after several court losses. Query whether this approach will be adopted in other circuits.

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Tip Jar Income

- “Tip jar” income is not subject to employer’s share of FICA taxes until the Service makes a notice and demand for taxes from the employer, CCA 200929004 (July 17, 2009).
 - Deliberate ignorance of amounts collected and distributed seems to support a respite from specific employer-collected FICA tax obligations.
 - However, employer made an estimate and paid on that basis, so no complete avoidance here.

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Legislation

- Pay particular attention to the **Emergency Economic Stabilization, Energy, Extenders, and AMT Relief Acts of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (October 3, 2008)**.
 - Disaster area relief provisions affect many Midwestern residents.
 - Some relief provisions don't seem so closely related to a disaster. E.g., Hope and Lifetime learning credits may be doubled if you merely attend an eligible institution in the disaster area in 2008 or 2009 (like Creighton).

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Late-Breaking Legislation

Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat. 2984 (Nov. 6, 2009).

- Extends first-time homebuyer credit beyond the prior deadline of November 30, 2009 to include purchases by April 30, 2010 (with closing by June 30, 2010). (Military serving outside the U.S. get an extra year.)
- Increases purchase price limitation to \$800K.
- For purchases after November 6, 2009, the credit will be phased out for single taxpayers with modified AGI between \$125K-\$145K (up from \$75K-\$95K purchases) and for married-filing-jointly taxpayers with modified AGI between \$225K-\$245K (up from \$150K-\$170K).
- Adds a credit for existing homeowners of up to \$3250 (single) and \$6500 (married filing jointly) based on 10% of purchase price for a new home where taxpayer has lived in his current home for five consecutive years.
- Removes some abuses from prior law (e.g., parents buying for minor children); retroactively classifies those attempts as "errors" under IRC 6213(g).
- Commentators note that this credit facilitates more purchases with no "skin in the game". See Robert C. Pozen, Homebuyer Tax Credits Threaten the FHA, Wall Street Journal, November 24, 2009.

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Late-Breaking Legislation

Worker, Homeownership, and **Business Assistance Act of 2009**, Pub. L. No. 111-92, 123 Stat. 2984 (Nov. 6, 2009).

- Extends eligibility for NOLs arising in 2008-2009 to be carried back from 2 to 5 years as elected by an eligible small business taxpayer.
- Election can be made by the due date for the taxpayer's 2009 taxable year return.
- Carryback to 5th year is limited to 50 percent of taxable income in that year.
- Small businesses electing carryback for 2008 under prior law are subject to limitations. So are TARP recipients!
- For further guidance, see Rev. Proc. 2009-52 (to be published in IRB 2009-49, 12/7/09).

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The Future (Through a Glass, Darkly)

- Treasury "Green Book" for 2010 available at <http://www.ustreas.gov/offices/tax-policy/library/grnbk09.pdf> includes:
- "Carried interests" in partnerships taxed as ordinary income (p. 23).
- Codification of Economic Substance (p. 25)
- Repeal of LIFO (p. 27) (which may be required for IFRS implementation) with LIFO reserve taken into income over 7 years.
- Lots of Foreign-Income related provisions
- Restrictions on deductions and credits for oil and gas production (p. 59-69).

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The Future (Green Book)

- Reinstatement of the 39.6 percent and 36 percent tax rates, Pease amendment impacts on itemized deductions, personal exemption phaseouts, and 20 percent capital gains rates (73-77).
- Eliminate capital gains taxation of investments in small business stock (13).
- R&E Credit is made permanent (p. 15).
- "Making Work Pay" credit extended (p.1).
- EITC expanded; marriage penalty relief, refundability of Child Tax Credit; automatic enrollment in IRAs for employers in business with 10 or more employees (p. 3-10).
- Permanent "American opportunity tax credit" in lieu of Hope and Lifetime Learning Credits.

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The Future: Other

- Treasury is discussing an extension of Form 1099 reporting duties to corporate payees. The AICPA has commented adversely on this proposal.
- Extenders bill expected in early December to address the usual suspects (R&D credit, deductions for sales taxes, AMT, etc.)
- Surtax to fund war (HR 4130 leaves the percentage up to the President (!?!)); imposed on broad range of taxable income).
- Health care, medicare reforms may impose high-income surtaxes that could translate into top marginal rates over 50 percent when all income-based taxes are included.

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