FEDERAL INCOME TAXATION—SELECTED RECENT DEVELOPMENTS

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I. LEGISLATION

Two significant tax bills were enacted in October 2004—the Working Families Tax Relief Act of 2004, P.L. 108–311 (October 4, 2004), and the American Jobs Creation Act of 2004, P.L. 108–357 (October 22, 2004). Following is a description of selected provisions of these tax acts.

A. Working Families Tax Relief Act of 2004

1. Extensions

   a. The child credit is extended at the $1,000 level through 2010. See section 24(a).¹

   b. The so-called “marriage penalty relief” provisions are extended through 2010. These provisions set the basic standard deduction for joint return filers at twice the amount for single filers (section 63(c)) and increase the 15-percent rate bracket for joint return filers to twice the amount for single filers (section 1(f)(8)).

   c. The higher alternative minimum tax (“AMT”) exemption amounts are extended through 2005 (section 55(d)(1)).

   d. Several credits scheduled to sunset in 2004 are extended.

   e. The elective expensing of qualified environmental remediation costs is extended through 2005. See section 198(h).


2. Uniform Definition of “Qualifying Child.” For taxable years beginning after 2004, a uniform definition of “qualifying child” applies for purposes of: (a) the dependency exemption, (b) the child credit, (c) the earned income

¹Except where otherwise indicated, all “section” references are to sections of the Internal Revenue Code of 1986, as amended, and all “Reg. §” references are to sections of the Treasury Regulations or Proposed Treasury Regulations, as the case may be.
credit, (d) the dependent care credit, and (e) head of household filing status. See section 152(c).

B. **American Jobs Creation Act of 2004**

1. **Introduction.** The genesis of the American Jobs Creation Act of 2004 (“AJCA”) was a long-running series of attempts by the United States to use the income tax system to provide export subsidies to United States exporters, all of which have been found to violate the United States’ international trade obligations. The most recent export subsidy was enacted in 2002 through the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106–519, 11/15/2000). That Act adopted section 114, the extraterritorial income (“ETI”) exclusion. In January 2002, the Dispute Settlement Body of the World Trade Organization determined that the ETI exclusion was an illegal trade subsidy. On August 30, 2002, a World Trade Organization arbitrator’s report ruled that the European Union was entitled to impose $4 billion in sanctions on U.S. exports. Following issuance of the report, efforts were undertaken to craft a WTO-compliant export tax benefit. Ultimately, those efforts were abandoned, and Congress and the Bush administration decided to replace the ETI exclusion regime with a broad-based tax benefit for domestic production activities. As both a technical and an economic matter, the latter tax benefit bears no relation whatsoever to the export-subsidy regime it replaces. Nonetheless, the repeal of ETI and the adoption of the benefit for domestic production activities are often referred to together in explanations of the AJCA.²

As is often the case with major tax legislation, the AJCA became a vehicle for an enormous number of major tax changes unrelated to the foreign trade issue that spawned the Act. Following is a description of selected provisions of the AJCA.

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²The only common element between the repeal of the ETI exclusion and the adoption of the benefit for domestic production activities is that the latter is phased in while the former is phased out.

a. Extraterritorial Income ("ETI") Exclusion Repealed. AJCA §101(a) repealed section 114, which provided the ETI exclusion. The repeal is subject to transitional relief. In 2005, taxpayers are permitted 80 percent of the benefits they would have received had the exclusion not been repealed, and in 2006, taxpayers are permitted 60 percent of such benefits. AJCA §101(d). Certain grandfather rules also apply. See AJCA §101(f).

b. Temporary Dividends Received Deduction for Repatriated Earnings of Controlled Foreign Corporations

i. AJCA §422(a) added new section 965, allowing a U.S. domestic corporation (the "taxpayer" for this purpose) a one-time opportunity to obtain an elective 85-percent dividends received deduction ("DRD") for certain cash dividends received from controlled foreign corporations.

ii. The election may be made for one taxable year only. The election may be made for the taxpayer’s last taxable year beginning before October 22, 2004, or for the taxpayer’s first taxable year beginning on or after October 22, 2004, and before October 22, 2005.

iii. The DRD under section 965 is subject to significant limitations, and, to the extent it applies, it has collateral consequences that may cause it to be unfavorable for some taxpayers.

iv. If the election is made, the resulting DRD applies only to cash dividends that are “invested in the United States pursuant to a domestic reinvestment plan.” The plan must provide for reinvestment in the U.S. as a source for “worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation.” Executive compensation is expressly excluded. Section 965(b)(4).
v. The DRD is available only with respect to dividends that are “extraordinary,” i.e., that exceed a historical baseline amount. Section 965(b)(2).

vi. The foreign tax credit (and the section 164 deduction) is denied for foreign taxes paid or accrued with respect to the deductible portion of a dividend for which the DRD is allowed. Section 965(d).

c. Repeal of the 90-Percent Limitation on Alternative Minimum Tax (“AMT”) Foreign Tax Credit. AJCA §421(a) repealed former section 59(a)(2), which generally allowed the foreign tax credit (as specially computed for AMT purposes) only to the extent of 90 percent of the precredit tentative minimum tax. The repeal is effective for taxable years beginning after 2004.

d. Foreign Tax Credit Rules Simplified in Several Respects

i. AJCA §404 simplified the foreign tax credit by generally reducing the number of foreign tax credit “baskets” from nine to two. Beginning after 2006, the foreign tax credit limitation will be separately computed only for “passive income” and “general income.”

ii. AJCA §403(a) provided that dividends from noncontrolled foreign subsidiaries are no longer subject to a separate limitation but instead are subject to a look-through rule like controlled foreign subsidiaries.

iii. A “domestic loss recapture” rule was provided, under which, if a taxpayer has an overall loss from domestic (U.S.) operations that reduces U.S. tax on foreign source income, subsequent U.S. source income may be recharacterized as foreign source, thus increasing the foreign tax credit limitation in the later year. (This rule is comparable to the preexisting rules requiring the “recapture” of an overall foreign loss.) Section 904(g), adopted by AJCA §402.
iv. The foreign tax credit carryback period was shortened from two years to one year, and the carryforward period was lengthened from five years to ten years. AJCA §417.

v. Most of the foregoing rules are effective for taxable years beginning after 2006, subject to various transitional rules.

e. Foreign Personal Holding Company and Foreign Investment Company Rules Repealed

i. AJCA §413(a) repealed the foreign personal holding company provisions of the Code (sections 551–558), effective for taxable years of foreign corporations beginning after 2004 and taxable years of U.S. shareholders with or within which such foreign corporation taxable years end.

ii. AJCA §413(a) also repealed the foreign investment company rules in sections 1246 and 127.

f. New Taxes Imposed on Corporate “Inversions”

i. AJCA §801 adopted new section 7874 to penalize U.S. corporations that undergo transactions that result in top-tier ownership of their business activities by foreign corporations. For purposes of this provision, a U.S. corporation undergoing such a transaction is referred to as an “expatriated entity,” the resulting foreign corporation is referred to as a “surrogate foreign corporation,” and the transaction in which ownership was transferred to the surrogate corporation is referred to as an “inversion.”

ii. If at least 60 percent of the stock (by vote or value) of a surrogate foreign corporation is held by former shareholders of the expatriated entity by reason of their former stock ownership of that entity (assuming the entity was a corporation), or by reason of comparable former ownership if the expatriated entity was a partnership, the expatriated entity is taxed on its “inversion gain” (without regard to net operating loss carryovers or credits) for ten years after the
inversion. The inversion gain is any income or gain recognized by the expatriated entity by reason of transfers or licenses of property as part of the inversion or to any related foreign person. Section 7874(a) and (d).

iii. If the surrogate foreign corporation is at least 80-percent owned by former owners of the expatriated entity, the foreign corporation is treated as a domestic corporation. Section 7874(b).

iv. These provisions are generally effective for taxable years ending after March 3, 2003, subject to a grandfather rule.

3. Deduction for Domestic Production Activities

a. Introduction

i. AJCA §102 adopted new section 199, which allows a deduction equal to a percentage of the taxpayer’s “qualified production activities income” (“QPAI”). The purpose of the provision is to reduce the effective tax rate applicable to income from production activities taking place in the U.S., presumably as an incentive for U.S. taxpayers to locate those activities in the U.S. rather than abroad.

ii. When fully phased in in 2010, the deduction is equal to 9 percent of QPAI. For taxable years beginning in 2005 or 2006, the deduction is equal to 3 percent of QPAI. For taxable years beginning in 2007, 2008, or 2009, the deduction is equal to 6 percent of QPAI. Section 199(a)(2).

iii. The deduction is allowed to all taxpayers, including both corporations and individuals.

iv. The deduction is allowed for purposes of the alternative minimum tax. Section 199(d)(6). It does not appear that the deduction is computed on a “parallel system” basis for AMT purposes.

v. In order to determine the amount of a taxpayer’s QPAI, it is necessary to identify the amount of the taxpayer’s gross receipts that
is derived from qualifying activities, and it is necessary to allocate the taxpayer’s expenses between those gross receipts and gross receipts from nonqualifying activities. Such factual determinations will likely be the subject of continuing disputes between taxpayers and the IRS.

vi. On January 19, 2005, the IRS published Notice 2001–14, providing initial guidance regarding section 199. The notice is discussed in part III. of this outline.

b. Will the Deduction Be Repealed by Congress?


This legislation was crafted to repeal an export tax benefit that was deemed inconsistent with obligations of the United States under the Agreement on Subsidies and Countervailing Measures and other international trade agreements. This legislation replaces the benefit with tax relief specifically designed to be economically equivalent to a 3-percentage point reduction in U.S.-based manufacturing (sic).³

The conferees recognize that manufacturers are a segment of the economy that has faced significant challenges during the nation’s recent economic slowdown. The conferees recognize that trading partners of the United States retain subsidies for domestic manufacturers and exports through their indirect tax systems. The conferees are concerned about the adverse competitive impact of these subsidies on U.S. manufacturers.

These concerns should be considered in the context of the benefits of a unified top tax rate for all corporate taxpayers, including manufacturing, in terms of efficiency and fairness. The conferees also expect that the tax-writing committees will explore a unified top corporate tax rate in the context of fundamental tax reform.

³ Presumably, Congress intended to reduce the tax on manufacturing income and not to reduce manufacturing itself.
ii. An April 6, 2005, article in *Tax Notes Today* states:

Backtracking on a provision he helped to write, Senate Finance Committee Chair Chuck Grassley, R–Iowa, expressed hope on April 5 that Congress would erase the recently enacted deduction for domestic production activities by reducing all corporate tax rates. . . . Before the provision was enacted, a number of influential lawmakers argued that separate tax rates for differing activities would be impossible to enforce and further complicate an already burdensome tax code. Grassley helped overcome those objections in conference negotiations last year, but speaking at an April 5 Tax Executives Institute (TEI) meeting in Washington, Grassley acknowledged that the domestic production activities deduction was not the ideal solution. “If you look at tax policy generally, it’s not good,” Grassley said of the measure. “We all accept that.”

iii. In light of the Conference Report language quoted above, Senator Grassley’s comments are not properly characterized as “backtracking.” In any event, the future of section 199 cannot be viewed as certain.

c. Computation of the Deduction

i. The base for determining the deduction is the smaller of the following amounts: (A) the taxpayer’s QPAI for the year and (B) the taxpayer’s taxable income (adjusted gross income in the case of an individual) for the year determined without regard to section 199. Section 199(a)(1).

ii. The deduction is limited to 50 percent of the “W–2 wages of the employer for the taxable year.” Section 199(b).

d. Qualified Production Activities Income (“QPAI”)

i. QPAI is equal to the excess of “domestic production gross receipts” over cost of goods sold and deductible expenses that are allocable to such gross receipts. Section 199(c)(1).
ii. Under section 199(c)(4), domestic production gross receipts generally include gross receipts derived from the following:

(A) A “lease, rental, license, sale, exchange, or other disposition” of tangible personal property or computer software, or property described in section 168(f)(4), if the property was manufactured, produced, grown, or extracted by the taxpayer “in whole or in significant part” within the U.S.;

(B) Construction performed in the U.S.;

(C) Engineering or architectural services performed in the U.S. for construction projects in the U.S.

iii. Only “trade or business” activities generate domestic production gross receipts. Section 199(d)(5).

iv. Receipts from transactions with related persons is not included in domestic production gross receipts. Section 199(c)(7).

e. Treatment of Affiliated Groups of Corporations

i. Affiliated groups of corporations are treated as a single taxpayer for purposes of section 199, and the group’s deduction is allocated among the group’s members. Section 199(d)(4)(A) and (C).

ii. Section 199 has a special definition of “affiliated group.” Section 199(d)(4)(B).

f. Treatment of Partnerships and Other Pass-Through Entities

i. In general, the deduction is calculated at the owner level, not at the entity level. Section 199(d)(1)(A)(i).

ii. There is a special rule for allocating a pass-through entity’s W–2 wages among its owners. See Section 199(d)(1)(B).

a. Introduction

i. AJCA §§811–822 add significant new weapons to the IRS to use in its war on tax shelters. Those new weapons include penalties on taxpayers and their “material advisors” for failure to disclose tax shelter transactions and stiffer penalties on understatements of tax resulting from tax shelters.

ii. The linchpin of the new rules is the definition of the terms “reportable transaction” and “listed transaction.”

iii. A “reportable transaction” is “any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.” Section 6707A(c)(1).

iv. A “listed transaction” is a reportable transaction that is “the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of Section 6011.” Section 6707A(c)(2).

v. The regulations under section 6011 list six types of reportable transactions. These include “listed transactions,” “confidential transactions,” “transactions with contractual protection,” “loss transactions,” “transactions with a significant book-tax difference,” and “transactions involving a brief holding period.” Most of these categories of transactions have minimum dollar thresholds. This is not the case, however, for listed transactions and transactions with contractual protection. See Reg. §1.6011–4(b).

4 The references to “listed transactions” are not circular, as they may appear. The term as used in the regulations is defined in Reg. §1.6011–4(b)(2), which reads: “Listed transactions. A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice.”
b. Taxpayer Penalty for Failure to Disclose Reportable Transactions

i. Under section 6707A, a substantial penalty is imposed on any taxpayer that fails to disclose information required under section 6011 to be disclosed about a reportable transaction on the taxpayer’s return.\(^5\)

ii. The penalty applicable to all reportable transactions is $10,000 for an individual and $50,000 for all other taxpayers. The penalty amounts are increased to $100,000 and $200,000, respectively, in the case of listed transactions. Section 6707A(b).

iii. The IRS has discretion to reduce or waive the penalty (other than in the case of a listed transaction) to promote compliance and effective tax administration. Section 6707A(d).

iv. The penalty under section 6707A is in addition to other penalties.

c. Material Advisor Penalty for Failure to Disclose Reportable Transactions

i. Section 6111(a), as amended by AJCA §815(a), requires a “material advisor” with respect to a reportable transaction to disclose certain information regarding the transaction.

ii. Section 6111(b) generally defines a “material advisor” as a person who provides material advice or other assistance with respect to “organizing, managing, promoting, selling, implementing, insuring, or carrying out” a reportable transaction and derives gross income for those activities in excess of specified thresholds. The minimum gross income threshold is $50,000. (It is not clear whether and how an advisor’s fees from related transactions are aggregated for this purpose.)

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\(^5\) The requirement to disclose information about “reportable transactions” is set forth in Reg. §1.6011–4. Section 6011 itself simply obligates tax return filers to include in their returns the information required by the regulations.
iii. Under section 6707, as amended by AJCA §816(a), a material advisor who fails to comply with the requirements of section 6111 with respect to a reportable transaction is subject to a $50,000 penalty for each such failure. In the case of a listed transaction, the penalty is the greater of: (A) $200,000, and (B) 50 percent of the gross income derived by the advisor with respect to the transaction.

iv. As in the case of the taxpayer penalty under section 6707A, the IRS has discretion to reduce or waive the penalty (other than in the case of a listed transaction) to promote compliance and effective tax administration. Section 6707(c).

d. New Accuracy-Related Penalty on Understatements Attributable to Reportable Transactions

i. Under new section 6662A, adopted by AJCA §812(a), a 20-percent penalty is applicable to a “reportable transaction understatement.” Section 6662A(a).

ii. There is a limited “reasonable cause” exception to the penalty under section 6662A. The taxpayer’s ability to rely on opinions provided by certain advisors is limited. See section 6664(d).

iii. In the case of a reportable transaction that reduces taxable income (from correct taxable income), the understatement is determined by multiplying the reduction in income by the highest applicable tax rate under section 1 or section 11.


a. Introduction

i. AJCA §885 adopted new section 409A. This provision imposes a variety of requirements on plans that are intended to defer compensation.

ii. The requirements imposed by new section 409A are in addition to other rules/doctrines that may prevent deferral of compensation,
such as the constructive receipt doctrine and the economic benefit doctrine.

iii. The consequences of failure to comply with section 409A are severe.

b. General Approach

i. Section 409A specifies requirements for a plan under which compensation is deferred.

ii. A “plan” includes any “agreement or arrangement,” even if it covers only one individual. Section 409A(d)(3).

iii. Section 409A does not apply to qualified pension and profit-sharing plans and various fringe benefits such as vacation time, sick leave, disability pay, and death benefits. Section 409A(d)(1).

iv. If the plan fails to satisfy those requirements at any time, all compensation that has previously been deferred under that plan may be affected.

c. Requirements for Deferral

i. “Distribution” Requirement. A plan may not permit deferred compensation to be distributed earlier than the occurrence of any of several specified events, including: (A) separation from service, (B) death, (C) disability, (D) a time specified at the time the deferral occurs, and (E) an unforeseen emergency. Section 409A(a)(2).

ii. “Acceleration” Requirement. Except as provided in regulations, the plan may not permit the acceleration of payments under the plan. Section 409A(a)(3).

iii. “Election” Requirement. In general, except as provided in regulations, an election to defer compensation must be made before the beginning of the taxable year in which the compensated services are performed. Section 409A(a)(4).
d. Consequences of Failure to Comply with Section 409A

i. If a plan fails to meet the section 409A requirements in any taxable year, all vested amounts of compensation otherwise deferred for the taxable year and all prior taxable years are included in the gross income of plan participants with respect to whom the failure occurs. Section 409A(a)(1)(A).

ii. Plan participants referred to above also must pay interest on the previously deferred compensation as if it were taxable in the year it became vested. Section 409A(a)(1)(B)(i)(I).

iii. Plan participants referred to above also must pay a “penalty” equal to 20 percent of the compensation required to be included in gross income. Section 409A(a)(1)(B)(i)(II).

iv. For purposes of these rules, the term “vested” is used here to mean “not subject to a substantial risk of forfeiture,” which itself is defined to mean conditioned on the performance of future services. Section 409A(d)(4).

e. Effective Date

i. AJCA §885(d)(1) generally provides that section 409A is effective for compensation deferred after 2004.

ii. AJCA §885(d)(2) provides that, if a plan is materially modified after October 3, 2004, amounts deferred before 2005 under the plan generally will be treated as deferred after 2004.

iii. The effectiveness of section 409A was postponed by the IRS in Notice 2005–1, explained in part II.A., below.


a. Treatment of Contributed Property with a Built-in Loss

i. Section 704(c)(1)(C), adopted by AJCA §833(a), provides that, if property contributed to a partnership by a partner has a built-in loss,
the loss may be taken into account only in determining items allocated to the contributing partner. For purposes of determining items allocated to the other partners, the basis of the contributed property generally must be treated as equal to its fair market value at the time of contribution.

ii. Note: Under section 704(c) before this amendment, deductions attributable to the built-in loss could be allocated to noncontributing partners if the contributing partner’s partnership interest was redeemed before those deductions were realized and the partnership did not have a section 754 election in effect.

iii. This provision is effective for contributions made after October 22, 2004.

b. Mandatory Adjustment of Basis of Partnership Property Where the Partnership Has a “Substantial Built-in Loss” When a Partnership Interest Is Transferred

i. Section 743, as amended by AJCA §833(b), provides that basis adjustments to partnership property that normally are made following the transfer of an interest in a partnership only if the partnership has a section 754 election in effect are mandatory if the partnership has a “substantial built-in loss” immediately after the transfer.

ii. In general, a partnership has a “substantial built-in loss” if the basis of its property exceeds the value of such property by more than $250,000. Section 743(d).

iii. This provision is effective for transfers made after October 22, 2004.
c. Mandatory Adjustment of Basis of Partnership Property Following a Distribution to a Partner Where There Is a “Substantial Basis Reduction”

i. Section 734, as amended by AJCA §833(c), provides that basis adjustments to partnership property that normally are made upon a distribution by a partnership to a partner only if the partnership has a section 754 election in effect are mandatory if the sum of: (A) any loss recognized by the distributee partner, and (B) the reduction in the basis of property distributed to the property, exceeds $250,000.

ii. In general, a partnership has a “substantial built-in loss” if the basis of its property exceeds the value of its property by more than $250,000. Section 743(d).

iii. This provision is effective for distributions made after October 22, 2004.

d. Clarification of Debt-Discharge Rules Where a Partnership Interest Is Issued in Satisfaction of Debt

i. Under AJCA §896(a), section 108(e)(8) is amended to provide that, where a partnership issues a partnership interest to a creditor in satisfaction of debt, the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the interest issued.

ii. As a result, the discharge of the debt may cause the partnership to recognize taxable gain.

iii. This provision is effective for cancellations of indebtedness after October 22, 2004.

7. S Corporation Provisions

a. Under section 1361(b)(1)(A), as amended by AJCA §232(a), the permissible number of shareholder is increased to 100.
b. Under section 1361(c)(1)(A)(ii), as amended by AJCA §231(a), for purposes of determining the number of an S corporation’s shareholders, all members of a family are treated as one shareholder.

For purposes of this rule, a “family” generally includes all lineal descendants of a common ancestor and their spouses. For this purpose, a “common ancestor” may not be more than six generations removed from the youngest living lineal descendant.

c. The foregoing provisions are effective for taxable years beginning after 2004.


a. Section 121(d)(10), as amended by AJCA §840(a), provides that, if property is acquired in a like-kind exchange to which section 1031 applies, the gain exclusion under section 121 does not apply to a sale or exchange of the property that occurs within five years after the exchange.

i. Note: As a technical matter, this rule appears to apply even if all of the gain realized on the like-kind exchange was recognized under section 1031(b) due to the receipt of “boot” in the exchange.

ii. This rule is effective for sales or exchanges after October 22, 2004.

b. Under section 168, as amended by AJCA §211, “qualified leasehold improvements” and “qualified restaurant property” may be depreciated over 15 years on a straight-line basis.

i. “Qualified leasehold improvement property” is defined in preexisting section 168(k).

ii. “Qualified restaurant property” is defined in new section 168(e)(7) to mean an improvement to a building if the improvement is placed in service more than three years after the building was first placed in serviced, and more than 50 percent of the square footage of the building is devoted to food preparation and sit-down dining.
iii. The foregoing depreciation rules apply only to property placed in service after October 22, 2004, and before January 1, 2006. See sections 168(e)(3)(E)(iv) and (v).

9. **Attorney Fees and Other Costs in Discrimination Suits.** AJCA §703(a) adopted new section 62(a)(20), which allows an above-the-line deduction (i.e., a deduction allowable in computing adjusted gross income) for attorney fees and court costs paid by or on behalf of the taxpayer in connection with certain specified discrimination claims, to the extent those fees and costs do not exceed the taxable amount received by the taxpayer.

The principal effect of this change is that, since the deduction is allowed in computing adjusted gross income, it is not a “miscellaneous itemized deduction,” as defined in section 67(b) (see section 63(d)(1)), and it is therefore not subject to: (A) the 2-percent floor on miscellaneous itemized deductions under section 67(a), (B) the phase-out of itemized deductions under section 68, or (C) complete disallowance for purposes of the alternative minimum tax under section 56(b)(1)(A)(i).

**II. DEFERRED COMPENSATION**


1. **Introduction**
   a. Notice 2005–1 provided substantial explanatory guidance regarding numerous terms and concepts in section 409A.

   b. Notice 2005–1 also provided transitional relief to enable employers and other service recipients the opportunity to bring plans into compliance with section 409A, or terminate them, without causing their employees or other service providers to be subject to the draconian rules of that provision.

   c. The rules provided by Notice 2005–1 are in Q&A format.
2. Transitional Rules

a. One-year grace period: A plan adopted before December 31, 2005, won’t be treated as violating the requirements of section 409A during 2005 if it is operated in good faith compliance with the applicable substantive rules and it is amended before the end of 2005 to conform to section 409A. Q&A 19.


i. A material modification occurs if a benefit or right existing under a plan as of October 3, 2004, is enhanced or a new benefit or right is added to the plan. Q&A 18.

ii. This means that a plan may be modified to comply with section 409A by restricting rights or benefits under the plan without causing a material modification, but the rights and benefits under the plan may not be enhanced, even in a manner that is permissible under section 409A, without causing a material modification.

iii. Note: If a material modification is made to a plan, pre-2005 deferrals under the plan will become subject to section 409A.

c. Freezing a noncompliant plan to stop future deferrals is not a material modification. Q&A 18(c).

d. Amending a plan to terminate it and distribute previously deferred compensation is not a material modification if it occurs on or before December 31, 2005, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs. Q&A 18(c).

Presumably, this means that, although the distributed amounts are included in the recipients’ taxable income, the interest charge and 20-percent additional tax under section 409A(a)(1)(B) are not imposed.
3. **Meaning of “Substantial Risk of Forfeiture”**

a. In order for compensation to be subject to a “substantial risk of forfeiture,” entitlement to the compensation must be conditioned on the performance of “substantial future services” or “the occurrence of a condition related to a purpose of the compensation” (such as the service recipient attaining a prescribed level of earnings). Q&A 10.

b. It is not sufficient to condition the right to compensation on the service provider’s refraining from performing services. Q&A 10. Thus, conditioning the receipt of deferred compensation on satisfying the terms of a noncompetition agreement does not create a substantial risk of forfeiture.

4. **Treatment of Nonqualified Stock Options and Stock Appreciation Rights**

a. A nonqualified stock option plan generally is not treated as deferring compensation as long as: (i) the exercise price is at least equal to the fair market value of the stock at the time the option is granted, (ii) the grant, transfer, or exercise of the option is subject to section 83, and (iii) the option does not include any unusual deferral features. Q&A 4(d)(ii).

b. Incentive stock options and options granted under employee stock purchase plans are not treated as deferring compensation. Q&A 4(d)(iii).

c. A stock appreciation right generally is not treated as deferring compensation if: (i) the “exercise price” is not less than the fair market value of the underlying stock at the time the right is granted, (ii) the underlying stock is traded on an established securities market, and (iii) the right does not involve any unusual deferral features. Q&A 4(d)(iv).


1. **Background.** Rev. Rul. 2002–22, 2002–1 C.B. 849, held that the transfer of nonstatutory stock options and nonqualified deferred compensation to a former spouse in a divorce is not a taxable event by reason of section 1041. The
transferee former spouse is instead taxed upon exercise of the options and upon receipt of the deferred compensation.

2. **Holdings of Rev. Rul. 2004–60**

   a. The transfer of stock to the former spouse upon exercise of a stock option and the payment to the former spouse of deferred compensation both are treated as wages to the same extent as if they had been transferred/paid to the employee.

   b. Income taxes are withheld from the payments and are treated as credits against the former spouse’s income tax obligation.

   c. Applicable FICA and FUTA taxes are withheld from the payments, are treated as payments of such taxes with respect to the employee, and are reported on W–2s issued to the employee.

### III. DEDUCTION FOR DOMESTIC PRODUCTION ACTIVITIES


1. Notice 2005–14 constituted an ambitious attempt by the IRS to provide guidance on a wide range of issues arising under section 199. Affected taxpayer groups have complained about several of the positions taken in the notice, and it is possible that there will be significant changes to some of those positions.

2. A detailed description of the issues covered by the notice is beyond the scope of this outline. The following sections explain some of the controversial positions taken in the notice.

**B. Controversial Positions Taken in the Notice**

1. **Exclusion of Land Sale Proceeds from Domestic Production Gross Receipts ("DPGR")**

   a. Section 4.04(11)(e) of the Notice states:
“Derived from construction. Assuming all other requirements of §199(c) are met, DPGR derived from the construction of real property performed in the United States includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not the property is sold immediately after construction is completed). DPGR derived from the construction of real property also includes compensation for the performance of construction services by the taxpayer in the United States. However, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or gross receipts attributable to the sale or other disposition of land.”

(Emphasis added.)

b. The Notice does not explain why land sale proceeds are excluded. The legislative history makes no reference to land sale proceeds. Some commentators have suggested that the exclusion is an antiabuse rule intended to prevent taxpayers from causing the section 199 deduction to apply to land investment profits by constructing minimal improvements on land before its sale.

c. Several taxpayer groups have objected to this provision. Some have suggested that the purpose described in the preceding paragraph could be achieved with a less draconian rule.

2. Identification of “Construction” Activities Related to Land

a. Under section 199(c)(4)(A)(ii), domestic production gross receipts include gross receipts derived from “construction performed in the United States.”

b. The Conference Report states: “[C]onstruction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure.” (H. Rep. No. 755, 108th Cong., 2d Sess., at 259, n.26.)

c. Section 4.04(11)(c) of the Notice states: “Definition of ‘infrastructure.’ The term ‘infrastructure’ includes roads, power lines, water systems,
railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring.”

d. Due to the omission of the word “only” from the foregoing language definition, it is possible that the IRS does not intend the quoted list be exclusive, but this is not clear. For example, it is not clear whether the IRS considers the construction of a golf course (other than the construction of related items listed in section 4.04(11)(c)) to be a construction activity.

3. Treatment of Contract Manufacturing Services

a. Section 199(c)(4)(A)(i)(I) provides that, in the case of manufacturing, “domestic production gross receipts” are gross receipts derived from sale or exchange, etc., of “qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer. . . .”

b. Section 4.04(4) of the notice states:

“Definition of ‘by the taxpayer.’ . . . [I]f one taxpayer performs a qualifying activity under §199(c)(4)(A)(i) pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity.”

c. Under this position, if a retailer pays a contractor to produce goods that will be marketed under the retailer’s brand, the party that has the benefits and burdens of ownership of the manufactured property during the production process will be the only party able to claim the deduction. If the contractor has the benefits and burdens of ownership, the deduction will be based only on the contractor’s profit. If the retailer has the benefits and burdens of ownership, the deduction will be based only on the retailer’s profit. If, on the other hand, the retailer self-produced the property, the deduction would be based on the overall profit. Several taxpayer groups have complained about this position in the notice.
4. Treatment of Engineering Services Not Performed in Connection with Real Property Construction Projects

a. Under section 199(c)(4)(A)(iii), domestic production gross receipts include gross receipts derived from “engineering or architectural services performed in the United States for construction projects in the United States.”

b. As noted above, the Conference Report states: “[C]onstruction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure.” (H. Rep. No. 755, 108th Cong., 2d Sess., at 259, n.26.)

c. Section 4.04(12)(a) of the notice states: “DPGR includes gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States (assuming all other requirements of §199(c) are met). The engineering or architectural services must relate to real property. . . .” (Emphasis added.)

d. Section 4.04(11)(b) of the Notice states: “Activities constituting construction. Activities constituting construction include activities performed in connection with a project to erect or substantially renovate real property. . . .” (Emphasis added.)

e. Some taxpayers have complained that there is no basis for limiting engineering services to construction projects involving real property. These taxpayers have referred, for example, to Rev. Rul. 69–412, 1969–2 C.B. 2, and Rev. Rul. 70–160, 1970–1 C.B. 7, which describe, respectively, an electric generating plant and a boiler that are treated as “tangible personal property” for purposes of the investment tax credit. These taxpayers question whether the IRS intends to deny the section 199 deduction to engineering services performed with respect to such projects and, if so, whether denying the deduction to such services is justified.
5. Treatment of Payments for Online Use of Server-Based Software

a. Section 199(c)(4) and (5) provide that domestic production gross receipts include gross receipts derived from the “lease, rental, license, sale, exchange, or other disposition” of property including “computer software.”

b. Section 4.04(7)(d) states:

“Computer software. Gross receipts derived from computer software (as defined in section 4.04(8)(c)) do not include gross receipts derived from Internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online access services, and other services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer.”

c. Several taxpayer groups have complained about this definition. As one commenter stated:

“There is nothing in the language or legislative history of section 199 that indicates any intent on the part of Congress to carve out and disqualify situations where the right to use software is granted to a customer but where the medium in which the software is embodied remains on the provider’s server.”

(Letter dated March 31, 2005, to Eric Solomon, Acting Assistant Secretary for Tax Policy, Department of the Treasury, and Donald Korb, Chief Counsel, IRS, from Joseph Tasker, General Counsel, Information Technology Association of America.)

6. Treatment of Receipts from Advertising on Online Versions of Newspapers and Magazines as Domestic Production Gross Receipts

a. Section 4.04(7)(c) states:

“Advertising income. Gross receipts that are “derived from” the sale or other disposition of newspapers and magazines include advertising income. For example, a newspaper manufacturer’s gross receipts from an advertiser to publish display advertising
or classified advertisements in its newspaper are treated as gross receipts derived from the sale of the newspapers (assuming all other requirements of §199 are met).”

b. Section 3.04(7)(c) explains:

“Advertising income. The Service and Treasury Department believe that advertising income attributable to the sale or other disposition of newspapers and magazines should be considered ‘derived from’ the sale or other disposition of the newspapers and magazines because the advertising income is inextricably linked to the gross receipts derived from the lease, rental, sale, exchange or other disposition of the newspapers and magazines.”

c. Interestingly, there is no basis in the legislative history for this position. It appears to be based entirely on the practical observation that gross receipts attributable to the production of newspapers and magazines are generally derived in the form of advertising revenues, and it departs from the literal language of the statute (which refers only to gross receipts derived from the “lease, rental, license, sale, exchange, or other disposition” of qualifying property).

d. In any event, some taxpayer groups have argued that, consistently with the apparent reasoning behind this position, advertising revenues from online versions of newspapers and magazines also should qualify as domestic production gross receipts.

e. Interestingly, the notice’s rule regarding advertising arguably conflicts with its treatment of payments for “provider-controlled software online access services,” described in part III.B.5., above.

IV. “TAX SHELTER” CASES

A. Introduction

Several major cases involving tax-oriented corporate transactions were decided during the past year. The IRS won one (Long-Term Capital Holdings) and lost the others.
It is difficult (although tempting) to draw broadly applicable conclusions from the cases, as the outcomes of the cases all were heavily dependent on their facts.

B. Taxpayer Couldn’t Rely on Tax Shelter Opinion to Avoid Penalty—*Long-Term Capital Holdings*, 330 F. Supp. 2d 122 (D. Conn. 2004)

1. Background

   a. The transaction in this case was designed to take advantage of the fact that, under section 704(c) as in effect before its amendment by the AJCA (see part I.B.6.b., above), deductions attributable to a contributed property’s built-in loss were preserved and allocated to a transferee of the contributing partner if the partnership did not have a section 754 election in effect.

   b. In the transaction under consideration in the case, four essential steps occurred. First, a nontaxable accommodation party generated a built-in loss property by stripping prepaid rent from a leased property and then contributing the leased property to a corporation in exchange for (high basis, low value) preferred stock. Second, the accommodation party contributed the preferred stock to a partnership controlled by the taxpayer. Third, the taxpayer purchased the accommodation party’s partnership interest for a small amount of money. Fourth, the partnership sold the preferred stock for a small amount of money and allocated the resulting loss to the taxpayer.

2. Holdings

   a. The court held for the government and sustained penalties against the taxpayer.

   b. First, the court held that the transaction lacked economic substance and should be disregarded. In the alternative, the court held that, under the step transaction doctrine, the taxpayer should be treated as having purchased the preferred stock from the accommodation party (resulting in a low cost basis for the stock).
c. More importantly, the court held that the taxpayer could not avoid the substantial understatement penalty on the ground that it relied on a favorable tax opinion. The court reached this conclusion on at least three (purportedly) independent grounds: First, the taxpayer could not prove that it received what it claimed was a reliance opinion before the relevant tax returns were filed. Second, the opinion by its own terms did not demonstrate why it was reasonable for the tax advisor to rely on the factual assumptions set forth in the opinion. Third, the taxpayer reported the claimed loss in a manner that, in the court’s view, was deceptive and was intended to avoid IRS detection.


1. Background
   a. The transactions in these cases involved the following pattern, which is typical of a significant number of large corporate transactions.
      i. The taxpayer transfers a high basis, high value asset (such as cash or securities) to a corporation in exchange for: (A) stock of the corporation, and (B) the corporation’s assumption of a contingent liability that the taxpayer has not yet accrued for tax purposes. The value of the contributed property is slightly larger than the (negative) present value of the liability. As a result, the stock received has positive, but minimal, value.

      ii. Under sections 351, 357, and 358, the taxpayer’s basis in the stock received in the exchange is intended to be equal to the basis of the transferred asset, unreduced by the contingent liability assumed by the transferee corporation.

      iii. The transferor subsequently sells the stock of the transferee corporation for its fair market value and claims a capital loss
approximately equal to the present value of the liability assumed by the transferee corporation.

b. In the Black & Decker case, the taxpayer’s newly formed subsidiary assumed the taxpayer’s contingent healthcare claims. In the Coltec case, the taxpayer’s newly formed subsidiary assumed the taxpayer’s contingent liability with respect to asbestos-related claims.

c. The government made various arguments, including: (i) the taxpayers’ principal purpose for having the subsidiaries assuming the contingent liabilities was avoidance of tax and, therefore, the basis of the stock received by the taxpayers should have been reduced by reason of money transfer deemed to occur under section 357(b), and (ii) the claimed losses should be disallowed because the transfers had no economic substance.

2. Holdings

a. The courts held for the taxpayers in both cases.

b. The courts held that the claimed losses were allowed under a correct reading of the applicable statutory principles.

c. The courts held that, under the facts of the cases, there was economic substance to, and a business purpose for, the prefunding and transfer of the taxpayer’s contingent liabilities.


1. Background

a. In this case, the taxpayer contributed cash and fully depreciated leased aircraft to a partnership that the taxpayer established with a foreign bank, which also contributed cash. Under the partnership agreement, 98 percent of the partnership’s operating income (book and tax) was allocated to the bank, and most of the partnership’s cash flow was distributed to the bank. The partnership had only a small amount of book
operating income (due to book depreciation on the aircraft), and the cash distributions therefore had the effect of liquidating the bank’s capital account over time. Because the aircraft had no depreciable tax basis, a large amount of taxable income was allocated to the bank. At the end of the partnership’s anticipated term, the bank’s capital account in the partnership was reduced to approximately zero.

b. The net effect of the arrangement was that the foreign bank made a substantial amount of cash available to the taxpayer throughout the term of the arrangement, the partnership allocations shifted taxable operating income away from the taxpayer during, and, at the end of the term, the taxpayer effectively owned all of the (low-basis) interests in a partnership that held cash.

c. The government argued that the partnership was a sham and should not be respected for tax purposes, so that the taxpayer should have been taxed on the partnership’s taxable income.

2. Holdings

a. The court held for the taxpayer.

b. The court reasoned that, under the facts of the case, the partnership had a business purpose and economic substance. It had a business purpose because the arrangement enabled the taxpayer to have access to the funds contributed by the bank—the taxpayer apparently had not been successful in its prior efforts to sell or encumber the aircraft. It had economic substance because the bank made a real investment and received a real return on the investment.

c. The court also observed that the partnership’s allocations had substantial economic effect.
V. CORPORATE REORGANIZATIONS

A. T.D. 9182—COSI and COBE Not Required for “E” and “F” Reorganizations


2. Content

   a. Continuity of shareholder interest (“COSI”) and continuity of business enterprise (“COBE”) requirements do not apply to reorganizations under section 368(a)(1)(E) (recapitalizations) and section 368(a)(1)(F) (mere changes in form)

   b. The amendments are effective for reorganizations occurring on or after February 25, 2005.

B. Proposed Regulations Would Limit Tax-Free Treatment for Certain “No Net Value” Transactions

1. Background

   a. Existing Reg. §1.332–2(b) states: “Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.”

   b. Rev. Rul. 59–296, 1959–2 C.B. 87, explains the rationale for this rule and its application (in the IRS’s view) to reorganizations under section 368:

      “Since all of the property of the subsidiary is worth less than the debt, no part of the transfer is attributable to the stock interest of the parent. The transaction is therefore neither a nontaxable distribution under section 332 of the Internal Revenue Code of 1954 nor a tax-free ‘reorganization’ under section 368(a)(1)(A) of the Code. See section 1.332–2(b) of the Income Tax Regulations. . . .”
2. **Event.** Proposed regulations dealing with “no net value” transactions were published on March 9, 2005. *See* Prop. Reg. §§1.332–2, 1.351–1, 1.368–1, and 1.368–2.

3. **Content.** The proposed regulations elaborate on Reg. §1.332–2(b) and impose a formal “net value” requirement on section 351 transactions and on all reorganizations under section 368(a)(1) other than “E” and “F” reorganizations.

C. **Proposed Regulations Would Permit Reorganization Treatment for Foreign Law Mergers**

1. **Background**
   a. Existing Reg. §1.368–2T(b)(1)(ii) provides: “Statutory merger or consolidation generally. For purposes of section 368(a)(1)(A), a statutory merger or consolidation is a transaction effected pursuant to the laws of the United States or a State or the District of Columbia. . . .” (Emphasis added.)

   b. Under this rule, a merger pursuant to the laws of a foreign jurisdiction cannot qualify as an “A” reorganization.

2. **Event.** Proposed regulations liberalizing the definition of “statutory merger or consolidation” were published on January 5, 2005. *See* Prop. Reg. §1.368–2(b)(1)(ii).

3. **Content**
   a. The new proposed regulations would replace the phrase “pursuant to the laws of the United States or a State or the District of Columbia” with the phrase “pursuant to the statute or statutes necessary to effect the merger or consolidation.”

   b. The preamble to the proposed regulations explains:

   “This proposed change would allow a transaction effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation under section 368(a)(1)(A), provided it otherwise qualifies as a reorganization. The phrase statute or statutes is not intended to prevent transactions effected pursuant to
legislation from qualifying as mergers or consolidations where such legislation is supplemented by administrative or case law.”


1. Background
   a. Neither the Code nor the regulations define the term “securities” for purposes of section 354.
   b. In general, under the case law, a debt instrument with a term of less than five years is not treated as a security.


3. Content
   a. The ruling provides that a debt instrument with two years to maturity that is issued by an acquiring corporation in a statutory merger in exchange for a debt instrument that had a 12-year term at the time of its original issuance but has two years to maturity remaining at the time of the merger is treated as a security in the following circumstances:
      i. The instrument (the “new debt”) is issued in exchange for a debt instrument of the acquired corporation (the “original debt”);
      ii. The new debt has the same terms (other than the interest rate) as the original debt.
   b. Because the new debt is treated as a “security,” it may be issued without causing the exchanging debt holder to recognize gain in the merger.
   c. Note: The old debt was assumed to be a “security,” presumably because of its 12-year original term.
VI. PARTNERSHIPS

A. Proposed Regulations on Disguised Sales of Partnership Interests

1. Background

   a. Section 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, if: (i) there is a transfer of money or property by a partner to a partnership, (ii) there is a “related direct or indirect transfer of money or other property by the partnership to such partner (or to another partner),” and (iii) the two transfers are properly viewed as a sale or exchange of property,” the transfers are to be treated as a transaction between the partnership and the partner acting in a nonpartner capacity “or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.” (Emphasis added.)

   b. In 1992, the IRS published regulations governing disguised sales of property to and from partnerships. See T.D. 8439. The IRS has not published final or temporary regulations governing disguised sales of partnership interests by one partner to another.

   c. In at least two technical advice memoranda, the IRS has taken the position that, even in the absence of regulations, section 707(a)(2)(B) may be applied to recast a transaction as a disguised sale of partnership interests. See TAM 200301004 (December 26, 2002) and TAM 200037005 (September 18, 2000).


3. Content

   a. General Rule. The structure of the proposed regulations is similar to the regulations governing disguised sales of property. That is, the proposed regulations generally provide:
“A transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner constitute a sale, in whole or in part, of the selling partner’s interest in the partnership to the purchasing partner only if, based on all the facts and circumstances—(i) The transfer of consideration by the partnership to the selling partner would not have been made but for the transfer of consideration to the partnership by the purchasing partner; and (ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.”


b. Rebuttable Presumption for Transfers Within Two Years. Like the regulations governing disguised sales of property, the proposed regulations contain a rebuttable presumption that transfers within two years of each other constitute a disguised sale. Prop. Reg. §1.707–7(c) provides:

“For purposes of this section, if within a two-year period a purchasing partner transfers consideration to a partnership and the partnership transfers consideration to a selling partner (without regard to the order of the transfers), the transfers are presumed to be a sale, in whole or in part, of the selling partner’s interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale.”

c. Exceptions to Rebuttable Presumption of Sale. The proposed regulations provide exceptions to the rebuttable presumption with respect to: (i) liquidating distributions, (ii) guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures, and (iii) transfers to and from service partnerships. See Prop. Reg. §§1.707–7(e), (f), and (g).

d. Treatment of Nonsimultaneous Transfers

i. If the distribution to the “selling partner” precedes the contribution by the “purchasing partner,” the proposed regulations treat the purchasing partner, as of the time of the distribution, as
having borrowed the distributed money from the partnership and using it to purchase the selling partner’s partnership interest. Prop. Reg. §1.707–7(a)(2)(i)(C).

ii. If the contribution by the “purchasing partner” precedes the distribution to the “selling partner,” the proposed regulations treat the purchasing partner, as of the time of the contribution, as having loaned the contributed money to the partnership in exchange for an obligation and, at the same time, using that obligation to purchase the partnership interest from the selling partner. Prop. Reg. §1.707–7(a)(2)(i)(D).

4. Public Reaction to the Proposed Regulations

a. There have been numerous complaints from commenters, many of whom have called for the withdrawal of the proposed regulations.

b. The principal complaints have related to the treatment of nonsimultaneous transfers. Commenters have complained about the complexity of the accounting involved and about the uncertainty of who is the owner of the partnership interest involved (e.g., for Form K–1 purposes) during the period between the transfers.

B. Revenue Rulings Regarding Application of “Mixing Bowl” Rules Following Partnership Mergers

1. Background

a. In a series of administrative actions relating to the application of the so-called “mixing bowl” rules following a merger of partnerships, the IRS capitulated to a well-orchestrated temper tantrum in the partnership tax bar.

b. In general, if a partner contributes appreciated property to a partnership, and either: (i) that property is contributed to another partner within seven years, or (ii) other nonmoney property is distributed to the contributing partner within seven years, the contributing partner must
recognize all or part of the remaining built-in gain attributable to the contributed property. See sections 704(c)(1)(B) and 737.

c. The regulations provide a rule under which, if a partnership merges into another partnership by transferring its assets in exchange for an interest in the transferee partnership and then liquidates, recognition under the foregoing provisions is deferred. Specifically, Reg. §1.704–4(c)(4) provides:

> Complete transfer to another partnership. Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See §1.737–2(b) for a similar rule in the context of section 737.

(Emphasis added.)

d. Several tax advisors advised their clients that, based on the italicized language above, a partnership whose contributed property had appreciated since the time of its contribution (“postcontribution gain”) could merge into another partnership and then distribute its property to partners of the other partnership without recognition of the postcontribution gain, on the ground that such gain would not have been recognized under section 704(c)(1)(B) had the transferor partnership distributed the property to any of its partners.

2. Events

a. In Rev. Rul. 2004–43, 2004–18 I.R.B. 842, published on April 12, 2004, the IRS took the position that, in such a transaction, the merger is a contribution of property that starts a new seven-year period with respect to the postcontribution gain.
b. Following the issuance of Rev. Rul. 2004–43, an extraordinary number of high-profile partnership tax practitioners castigated the IRS for making the revenue ruling “retroactive,” arguing that it was inconsistent with the plain language of the regulation quoted above.


1. **Background.** Oregon’s business entity laws, like the laws of many states, include provisions permitting a business entity of one form (e.g., an LLC) to convert into another form (e.g., a corporation) without actually forming a new entity and merging into it. Such a law is generally known as a “formless conversion” law. The relevant Oregon statutes are ORS 60.472 (conversion to and from corporation status), ORS 63.470 (conversion to and from LLC status), ORS 67.342 (conversion to and from partnership form), and (redundantly) ORS 70.505 (conversion to and from limited partnership form).


3. **Content**

   a. Rev. Rul. 2004–59 provides that when an entity that is classified as a partnership for federal tax purposes converts to a state law corporation under a formless conversion statute, the following is deemed to occur: First, the partnership is deemed to contribute its assets and liabilities to a new corporation in exchange for stock in the corporation. Second, the partnership is deemed to distribute the stock to its partners in liquidation.

   b. Note: These are the same steps that are deemed to occur if an entity classified as a partnership elects to be classified as an association taxable as a corporation pursuant to Reg. §301.7701–3(c)(1)(i).
D. T.D. 9126—Revaluation of Capital Accounts Following Grant of Partnership Interest to Service Partner

1. Background

a. In general, under section 704(b), profit and loss allocations in a partnership agreement will be respected only if the allocations have “substantial economic effect” (or are otherwise “in accordance with the partners’ interests in the partnership”).

b. Under Reg. §1.704–1(b), a partnership’s profit and loss allocations will be considered to have substantial economic effect only if, among other things, the partnership maintains capital accounts for the partners in accordance with Reg. §1.704–1(b)(2)(iv).

c. One portion of Reg. §1.704–1(b)(2)(iv) deals with adjustments to the partners’ capital accounts to reflect unrealized changes in the value of partnership property when events occur that require a determination and allocation of the partners’ respective shares of those unrealized changes in value. For example, Reg. §1.704–1(b)(2)(iv)(f)(5)(i) provides that a partnership may revalue its property and allocate the adjustments among the partners when a partner contributes money or property to the partnership in exchange for an interest in the partnership.

d. In the absence of a revaluation, distortions in the partners’ economic deal may occur. For example, if an incoming partner contributes $1,000 to a partnership in exchange for a $1,000 capital account and a 5-percent profits interest at a time when the partnership owns appreciated property, the incoming partner will ultimately capture 5 percent of the appreciation if no corrective steps are taken. This is avoided (if the partners want to avoid it) by “booking up” the property and allocating the appreciation to the other partners at the time of the new partner’s entry.

e. When a partner receives an interest in partnership profits in exchange for services, the partner receives no immediate capital account. In the
absence of a “book up,” however, the new partner may indirectly receive
an immediate interest in partnership capital.


3. Content

a. New Reg. §1.704–1(b)(2)(iv)(f)(5)(iii) provides that a partnership’s
capital accounts may be adjusted to reflect the fair market value of its
assets:

“In connection with the grant of an interest in the partnership
(other than a de minimis interest) on or after May 6, 2004, as
consideration for the provision of services to or for the benefit
of the partnership by an existing partner acting in a partner
capacity, or by a new partner acting in a partner capacity or in
anticipation of being a partner.”

b. Note: Even before this regulation was adopted, many practitioners
believed it was appropriate for partnerships to revalue partners’ capital
accounts upon the issuance of a profits interest to a service partner, relying
on Reg. §1.704–1(b)(2)(iv)(q), which reads:

Adjustments where guidance is lacking. If the rules of this
paragraph (b)(2)(iv) fail to provide guidance on how
adjustments to the capital accounts of the partners should be
made to reflect particular adjustments to partnership capital on
the books of the partnership, such capital accounts will not be
considered to be determined and maintained in accordance
with those rules unless such capital account adjustments are
made in a manner that (1) maintains equality between the
aggregate governing capital accounts of the partners and the
amount of partnership capital reflected on the partnership’s
balance sheet, as computed for book purposes, (2) is consistent
with the underlying economic arrangement of the partners,
and (3) is based, wherever practicable, on Federal tax
accounting principles.

1. Background

a. IRS audits generally are handled at the partnership level under so-called “unified audit procedures” (see generally sections 6221 to 6234), other than in the case of certain “small partnerships.” Section 6231(a)(1)(B).

b. Section 6231(a)(1)(B)(i) defines a “small partnership” as “any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.”


3. Content

a. Rev. Rul. 2004–88 holds that where one of a partnership’s partners is a wholly owned LLC that is treated as a disregarded entity under Reg. §301.7701–3(b)(1)(ii), the partnership cannot be a “small partnership” on the grounds that: (i) Reg. §301.6231(a)(1)–1(a)(2) provides that the small partnership exception does not apply if any partner during the taxable year is a “pass-thru partner” as defined in section 6231(a)(9), and (ii) section 6231(a)(9) defines “pass-thru partner” as “a partnership, estate, trust, S corporation, nominee or other similar person through whom other persons hold an interest in the partnership. . . .”

b. The ruling also holds that, where the disregarded entity is the partnership’s sole general partner, the LLC may be designated the “tax matters partner” for the partnership. The ruling does not expressly state that the LLC’s owner may not be designated the tax matters partner—the intent of the ruling in this regard is unclear.
VII. DISREGARDED ENTITIES


1. Rev. Rul. 2004–77, 2004–31 I.R.B. 119, August 2, 2004, held that, where an entity that is eligible to be classified as a partnership has two owners, one of which is a disregarded entity owned by the other, the two-legal-owner entity is treated as having only one member and cannot be classified as a partnership.

2. There is nothing surprising about this conclusion.

B. T.D. 9183—Disregarded Entities Recognized for Purposes of Taxes for Which They Are Liable

1. T.D. 9183, published on February 24, 2005, adopted several regulations providing that disregarded entities are treated as real entities for purposes of taxes for which they are liable. See new Reg. §1.856–9, new Reg. §1.1361–4(a)(6), and new Reg. §301.7701–2(c)(2)(iii). The three regulations are identical except to the extent that they refer to different types of disregarded entities.

2. The following language in Reg. §301.7701–2(c)(2)(iii) is representative:

   Tax liabilities of certain disregarded entities—(A) In general. An entity that is otherwise disregarded as separate from its owner is treated as an entity separate from its owner for purposes of:

   (1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded.

   (2) Federal tax liabilities of any other entity for which the entity is liable.

   (3) Refunds or credits of Federal tax.

1. Rev. Rul. 2004–41, 2004–18 I.R.B. 879, April 30, 2004, ruled that the IRS may not collect an LLC’s unpaid employment taxes from its members if they are not liable for the LLC’s debts under state law.

2. The ruling notes, however, that in some cases an exception may apply.

   a. First, there may be special circumstances such as a fraudulent transfer of assets from the LLC to its members, which might expose the members to liability. See generally Scott v. Commissioner, 236 F.3d 1239 (10th Cir. 2001) (imposing transferee liability under section 6901 on person receiving fraudulent transfer of assets from taxpayer-corporation); Stanko v. Commissioner, 209 F.3d 1082 (8th Cir. 2000) (same).

   b. Second, depending on the facts, a member who is responsible for collecting and depositing the taxes may be liable for the penalty imposed by section 6672.

VIII. DEPRECIATION AND ACCOUNTING METHODS


1. Background

   a. Reg. §1.451–1(a) provides: “Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.”

   b. The IRS has long taken the position that “[a]ll the events that fix the right to receive income under an accrual method of accounting occur when (1) the required performance occurs, (2) payment therefor is due, or (3) payment therefor is made, whichever happens first.” See, e.g., Rev. Rul. 84–31, 1984–1 C.B. 127.
c. Reg. §1.451–5 permits the deferral of advance payments for certain types of goods for taxpayers whose financial statements are consistent with such deferral.

d. The courts have adopted two principles under which advance payments generally may be deferred in appropriate cases. According to the first principle (the “deposit principle”), an advance payment may be deferred in some cases if the person making the payment has a legally enforceable right to demand a refund of the unearned part of the deposit at any time. The deposit principle was articulated by the United States Supreme Court in Commissioner v. Indianapolis Power & Light, 493 U.S. 203 (1990).

e. According to the second principle (the “predictable services principle”), an advance payment for services may be deferred in some cases if the payment relates to services that will be performed at predictable times in the future. The predictable services principle has been articulated in cases such as Beacon v. Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955) (prepaid newspaper subscriptions); Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968) (receipts from season tickets sold by the owner of a professional baseball team); and Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956) (prepaid contracts to turn gas furnace on and off once a year for five years). However, several Supreme Court cases have held that the predictable services principle does not apply to advance payments for services that will be performed, if at all, only when they are requested by the payor. See Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); American Automobile Association v. United States, 367 U.S. 687 (1961); Schlude v. Commissioner, 372 U.S. 128 (1963).

f. In situations to which the foregoing principles do not apply, taxpayers generally have not been successful in deferring advance payments except to the extent authorized by IRS procedures.

g. Since 1971, Rev. Proc. 71–21, 1971–2 C.B. 549, has been available “to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax
purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year.”

h. Over the years, the IRS experienced considerable controversy with taxpayers regarding the scope of Rev. Proc. 71–21. The controversy included disagreements about whether particular advance payments were for “services.” Also, taxpayers argued that the Revenue Procedure should apply to payments received for combinations of services and nonservices.

i. In Notice 2002–79, 2002–2 C.B. 964, the IRS released a proposed Revenue Procedure intended to expand the range of situations in which limited deferral of advance payments would be permitted.


3. Content

a. Rev. Proc. 2004–34 generally permits accrual-basis taxpayers receiving advance payments for services, the sale of goods, the use of property, warranty contracts, subscriptions, memberships in organizations, and combinations of the foregoing to adopt or retain an accounting method under which an advance payment is accrued in the year of receipt to the extent it is earned in the year of receipt and, to the extent of the remaining portion of the payment, is accrued in the following year.

b. Section 5.02(3)(a) of Rev. Proc. 2004–34 provides that, if the taxpayer has an “applicable financial statement,” it must determine the portion of the payment earned in the year of receipt in accordance with the method utilized in that financial statement.

c. Under section 5.02(3)(b) of the revenue procedure, if the taxpayer does not have an applicable financial statement, the taxpayer may determine the amount earned in the year of receipt under one of the following methods:

(i) on a statistical basis if adequate data are available to the taxpayer;
(ii) on a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(iii) by the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

d. Section 8 of the revenue procedure provides procedures for changing the taxpayer’s method of accounting to adopt a method authorized by the revenue procedure.

B. **Rev. Rul. 2004–18—Inventory Treatment of Manufacturer’s Expenditures to Clean up Hazardous Waste**

1. **Background**

   a. Rev. Rul. 94–38, 1994–1 C.B. 35, ruled that, where a taxpayer incurred costs to clean up land that taxpayer contaminated with hazardous waste from the taxpayer’s manufacturing business, the costs were not capital expenditures because they did not prolong the useful life of the land or adapt the land to a new or different use.

   b. The IRS realized that the conclusion stated in Rev. Rul. 94–38 was overstated. The IRS had only intended to rule that the clean-up costs in question were not capital expenditures with respect to the land.


3. **Content.** Rev. Rul. 2004–18 holds that, where a taxpayer engaged in a manufacturing process incurs clean-up costs of the type described above, those costs “are incurred by reason of [the taxpayer’s] production activities within the meaning of [Reg. §]1.263A–1(e)(3)(i).” Therefore, the taxpayer must capitalize the otherwise deductible environmental remediation costs “by including the costs in inventory costs in accordance with [Reg. §] 1.263A–1(c)(3).”
C. T.D. 9132—Application of MACRS Rules When Use of Property Changes


2. Content

a. Conversion from Personal Use to Depreciable Use. When property is converted from personal use to business or income-producing use, it is treated as if it had been placed in service on the conversion date, and it is subject to the applicable depreciation method, recovery period, and placed-in-service convention beginning in the tax year of the conversion. The property’s depreciable basis in the year of the change is the lesser of: (i) its fair market value and (ii) its “adjusted depreciable basis” (as defined in Reg. §1.168(b)–1T(a)(4)) at the time of the conversion. Reg. §1.168(i)–4(b)(1).

b. Conversion to Faster Depreciation Method. If the use of depreciable property is changed so that it is eligible for a shorter recovery period and/or a faster depreciation method, the property’s adjusted depreciable basis as of the beginning of the change year generally is depreciated over the shorter recovery period and/or by the faster depreciation method beginning with the year of change as though the property were first placed in service in that year. Reg. §1.168(i)–4(d)(3). Taxpayers may elect, however, to continue to depreciate the property as though the change in use had not occurred. Reg. §1.168(i)–4(d)(3)(ii). Such an election may be advantageous where the new “shorter” recovery period is longer than the remaining portion of the original longer recovery period.

c. Conversion to Slower Depreciation Method. If the use of depreciable property is changed so that it is subject to a longer recovery period and/or slower depreciation method, the property’s adjusted depreciable basis is depreciated over the longer recovery period and/or by the slower depreciation method beginning with the year of change as though the property had been originally placed in service with the longer recovery period and/or slower depreciation method. Reg. §1.168(i)–4(d)(4).
D. **Chief Counsel Notice 2004–007—Administrative Relief for Certain Changes in Computing Depreciation**

1. **Background**
   a. The IRS historically has taken the position on audit and in litigation that a change in computing depreciation generally is a change in method of accounting under section 446(e) for which the Commissioner’s consent is required.
   
   b. The IRS had mixed success sustaining this position in the courts. Prior to 2004, the Tax Court and the Fifth and Eighth Circuits had held that a change in a property’s MACRS classification is not a change in method of accounting that requires IRS consent under section 446. *Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner*, 320 F.3d 507 (5th Cir. 2003), aff'g T.C. Memo. 2001–150; *O’Shaughnessy v. Commissioner*, 332 F.3d 1125 (8th Cir. 2003); *Green Forest Manufacturing Inc. v. Commissioner*, T.C. Memo. 2003–75. The Tenth Circuit, on the other hand, had held that a change in recovery period under MACRS is an accounting method change. *Kurzet v. Commissioner*, 222 F.3d 830 (10th Cir. 2000).
   
   c. On December 16, 2003, the IRS published T.D. 9105, adopting temporary regulations under section 446 that require most changes in computing depreciation (or amortization) to be treated as accounting method changes under section 446.
   
   d. The changes adopted by T.D. 9105 were made effective for taxable years ending on or after December 30, 2003.


3. **Content**
   a. The Chief Counsel Notice, described as a “change in litigating position,” states:
“[F]or depreciable or amortizable property placed in service by the taxpayer in taxable years ending before the effective date of Treas. Reg. §1.446–1T(e)(2)(ii)(d), the Service will not assert that a change in computing depreciation . . . depreciable or amortizable property that is treated as a capital asset under the taxpayer’s present and proposed methods of accounting is a change in method of accounting under section 446(e).”

b. By way of illustration, the Chief Counsel Notice states:

“[I]f, for example, a taxpayer completes a cost segregation study in 2004 for its MACRS property placed in service in 2001 and, as a result, reclassifies that property from nonresidential real property to 15-year property under section 168(e), the Service will not assert that the change in computing depreciation resulting from this reclassification is a change in method of accounting under section 446(e) and, accordingly, the taxpayer may file amended federal tax returns for 2001 and any affected subsequent taxable year to effect this change in computing depreciation.”

c. Note: The IRS’s change in litigation position does not apply with respect to property placed in service in taxable years ending on or after December 30, 2003.

IX. EXEMPT ORGANIZATIONS—REV. RUL. 2004–51—PARTICIPATION BY EXEMPT ORGANIZATION IN PARTNERSHIP

A. Background

1. When an exempt organization transfers all or a portion of its assets to a partnership or LLC in which a significant ownership interest is held by a for-profit person, the organization risks losing its tax-exempt status on the ground that its activities are no longer operated exclusively for charitable purposes or on the related ground that it is operated for the benefit of private interests. See Reg. §§1.501(c)(3)–1(c)(1) and 1.501(c)(3)–1(d)(1)(ii).

2. Rev. Rul. 98–15, 1998–1 C.B. 718, set forth a fact template under which a section 501(c)(3) hospital organization did not lose its exemption where it
contributed *all of its assets* to an LLC, which then conducted the organization’s activities. The ruling emphasized that, under the LLC’s governing documents, the organization’s charitable purposes were given priority, and the organization retained control over the LLC.

3. In *St. David’s Health Care System v. United States*, 349 F.3d 232, 236–237 (5th Cir. 2003), a case involving a “whole hospital” partnership, the Fifth Circuit held that the exempt partner must have the “capacity to ensure that the partnership’s operations further charitable purposes.” *Id.* at 243. The court stated: “[T]he non-profit should lose its tax-exempt status if it cedes control to the for-profit entity.” *Id.* at 239.

4. Exempt charitable organizations frequently enter into joint ventures with for-profit entities in which only a portion of the organization’s activities are conducted through the joint venture.

B. Event


C. Content

1. The ruling presents a fact pattern in which a university that conducts seminars for schoolteachers forms a 50/50 LLC with a for-profit company that conducts interactive video training programs. The LLC’s sole purpose is to offer teacher training seminars at off-campus locations using interactive video technology.

   “The university has the exclusive right to approve the curriculum, training materials, and instructors while the company has the exclusive right to choose the locations where participants can get a video link to the seminars and to approve personnel such as camera operators. All other actions must have the mutual consent of the university and the company.”

2. The ruling addresses two questions: (a) whether participation in the LLC affects the university’s exempt status; and (b) whether the activities of the LLC constitute an unrelated trade or business within the meaning of section 512.
3. The ruling holds that because the activities that the university conducts through the LLC are not a substantial part of its activities, the university’s participation in the LLC, “taken alone,” will not affect its exempt status.

This aspect of the ruling apparently is intended to emphasize that the insubstantiality of an exempt organization’s ancillary joint venture activity will prevent the activity from causing the organization to violate the requirement that the organization be operated exclusively for exempt purposes, independently of the organization’s degree of control over the joint venture’s activities.

4. The ruling further holds that, because the LLC’s activities are “substantially related” to the university’s educational purposes, those activities do not constitute an unrelated trade or business. In making this determination, the ruling emphasized the university’s control over: (a) the “curriculum, training materials and instructors,” and (b) the “standards for successfully completing the seminars.”

D. Observations

1. The ruling does not require that the exempt organization have more than 50-percent control over an ancillary joint venture in order to ensure that the joint venture’s activities may be treated as “substantially related” to the organization’s exempt purposes.

2. The ruling states as a fact that the organization’s participation in the LLC “will be an insubstantial part of [the organization’s] activities within the meaning of §501(c)(3) and §1.501(c)(3)–1(c)(1) of the Income Tax Regulations.” Thus, it provides no guidance on how to determine whether an organization’s participation in a joint venture constitutes a substantial part of its activities.

3. The ruling emphasizes that all transactions entered into by the LLC will be “at arm’s length and for fair market value.” Therefore, the ruling does not present facts under which the activities conducted by the LLC may result in violating the absolute prohibition against so-called “private inurement.” See section 501(c)(3) and Reg. §§1.501(c)(3)–1(c)(2) and 1.501(a)–1(c).
X. ATTORNEY FEES

A. Supreme Court Ruling in Banks/Banaitis

1. Background

   a. There has been a split among the circuits as to the proper tax treatment of contingent fees paid to an attorney out of a taxable damage award or settlement. Some courts have held that such fees may be excludible from the client’s gross income in some cases. Other courts have held that such fees are always includible in the client’s gross income and may be deductible to the extent allowed by the rules governing deductions.

   b. In Banaitis v. Commissioner, 340 F.3d 1074 (9th Cir. 2003), the Ninth Circuit held that, because of the particular lien rights granted to attorneys under Oregon law, certain contingent fees paid directly to the Oregon taxpayer’s attorney pursuant to a settlement agreement were excludible from the taxpayer’s income.

   c. The principal significance of the issue is that, in many cases, a payment of attorney fees has been allowable only as a “miscellaneous itemized deduction” and therefore is not allowable for purposes of the alternative minimum tax. See sections 56(b)(1)(A)(i), 63(d)(1), and 67(b).

2. Event. On December 24, 2005, the U.S. Supreme Court decided Commissioner v. Banks, 125 S. Ct. 826, reversing the Ninth Circuit’s decision in Banaitis.

3. Content

   a. The Supreme Court stated: “We hold that, as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.”

   b. The Court reasoned that “a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client’s income from any litigation recovery.”
B. Implications—Limited Effect of AJCA

1. As noted above, AJCA §703(a) adopted new section 62(a)(20), which allows an above-the-line deduction (i.e., a deduction allowable in computing adjusted gross income) for attorney fees and court costs paid by or on behalf of the taxpayer in connection with certain specified discrimination claims.

2. However, there are many types of taxable, nonbusiness, damage claims that are not covered by section 62(a)(20) (e.g., defamation, false imprisonment, etc.). Attorney fees paid with respect to such claims continue to be disallowed for alternative minimum tax purposes.

C. Open Issues

1. The Banks decision expressly did not address the treatment of attorney fees that are imposed on defendants under so-called “fee shifting” statutes that authorize fee awards to prevailing plaintiffs’ attorneys.

2. The Banks decision expressly did not address the argument that “litigation recoveries are proceeds from disposition of property, so the attorney’s fee should be subtracted as a capital expense pursuant to §§1001, 1012, and 1016. . . .”

XI. LIKE-KIND EXCHANGES


1. Background


   b. In general, Rev. Proc. 2000–37 authorizes exchanges that follow one of two patterns. Under the first pattern, the taxpayer causes an accommodation party (referred to as an “exchange accommodation
titleholder,” or “EAT”) to acquire replacement property until the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee. Once that arrangement is made, the taxpayer transfers the relinquished property to the EAT in exchange for the replacement property, and the EAT transfers the relinquished property to the ultimate transferee. Under the second pattern, the EAT acquires the replacement property and immediately transfers that property to the taxpayer in exchange for the relinquished property. Following that exchange, the EAT holds the relinquished property until the taxpayer arranges for it to be transferred to the ultimate transferee. An arrangement complying with Rev. Proc. 2000–37 is referred to as a “qualified exchange accommodation arrangement,” or “QEAA.”

c. Section 4.01 of Rev. Proc. 2000–37 provides that the Internal Revenue Service “will not challenge the qualification of property as either ‘replacement property’ or ‘relinquished property’ (as defined in §1.1031(k)–1(a)) for purposes of section 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes” if the provisions of the revenue procedure are followed.

d. The IRS became aware that some practitioners interpreted the quoted language as permitting a taxpayer to treat as a like-kind exchange a transaction in which the taxpayer transfers property to an EAT and receives that same property (enhanced with improvements constructed by the EAT) as replacement property in a purported exchange for other property of the taxpayer. The IRS reportedly has not decided whether or not it believes that such exchanges should qualify under section 1031, but it did not intend Rev. Proc. 2000–37 to bless the tax-free treatment of such exchanges.

3. Content

a. Rev. Proc. 2004–51 modified the language of section 4.01 of Rev. Proc 2000–37 to read as follows:

   In general. The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefore, qualify as either “replacement property” or “relinquished property” (as defined in §1.1031(k)–1(a)) in a tax-deferred like-kind exchange if the exchange otherwise meets the requirements for deferral of gain or loss under §1031 and the regulations thereunder.

b. Rev. Proc. 2004–51 also added a new section 4.05 to Rev. Proc. 2000–37, to read as follows: “Limitation. This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder.”

4. Implications

a. If a taxpayer owns property with a value equal to its basis, a transaction in which the taxpayer sells the property to an EAT and then transfers low-basis property to the EAT in exchange for the property will not qualify under the safe harbor provided by the two revenue procedures.

b. Some tax practitioners have asserted after the publication of Rev. Proc. 2004–51 that, if the taxpayer enters into a 30-year, market rent, ground lease with the EAT, and the EAT thereafter constructs improvements on the leased land, Rev. Proc. 2004–51 should not prevent the safe harbor from applying if the taxpayer transfers low-basis property to the EAT in exchange for the EAT’s leasehold interest in the improved property. Those practitioners reason that the taxpayer never owned the improvements and that the language in Rev. Proc. 2004–51 therefore does not apply. IRS representatives, however, have informally stated that Rev. Proc. 2004–51 is intended to cover such transactions. See “IRS Officials Clarify Like-Kind
B. **T.D. 9115—Application of MACRS to Property Acquired in Like-Kind Exchanges and Involuntary Conversions**

1. **Background**

   a. When property is acquired in an exchange to which section 1031 applies, the basis of the acquired property is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by the amount of gain (or decreased by the amount of loss) that was recognized in the exchange. Section 1031(d). If the taxpayer acquires property in exchange for like-kind property and: (i) money, and/or (ii) nonlike-kind property, the basis of the acquired property will also include the amount of money and/or the value of the property transferred. See, e.g., Reg. §1.1031(d)–1(e).

   b. Under section 1033(b)(2), if the taxpayer’s property is involuntarily converted into money, and the taxpayer acquires replacement property and makes the necessary election, the basis of the replacement property acquired generally is equal to the cost of that property, decreased by any gain not recognized by reason of section 1033(a)(2).

2. **Event.** T.D. 9115, published on February 27, 2004, adopts temporary regulations providing guidance on the depreciation of MACRS property that is acquired either: (a) in exchange for like-kind MACRS property under section 1031, or (b) to replace involuntarily converted MACRS property under section 1033.

3. **Content**

   a. **Two Components.** The temporary regulations divide the basis of the acquired property into two components: (i) depreciable exchanged basis, and (ii) depreciable excess basis.
b. **Depreciable Exchanged Basis.** The depreciable exchanged basis generally is the portion of the replacement property’s depreciable basis that is attributable to the relinquished property.

   i. If both the replacement and relinquished properties have the same recovery period and depreciation method, the depreciable exchanged basis is written off over the remaining recovery period of, and using the depreciation method applicable to, the relinquished property. Reg. §1.168(i)–6T(c)(3)(ii).

   ii. Different (and more complex) rules apply where the recovery period and/or depreciation method are different.

c. **Depreciable Excess Basis.** The depreciable excess basis generally is the excess of the basis of the replacement property over its depreciable exchanged basis.

   Any excess basis in the replacement property is treated as property that is placed in service by the taxpayer in the year of replacement. Reg. §1.168(i)–6T(d)(1)(i).

d. **Election Out.** Computing depreciation under the temporary regulations can be complex and burdensome. If a taxpayer makes an appropriate election, the entire basis of the replacement property generally will be treated as property that is placed in service by the taxpayer in the year of replacement. Reg. §1.168(i)–6T(i).

### XII. PRACTICE BEFORE THE IRS—CIRCULAR 230 REVISIONS

A. **Background**

   1. 31 U.S. Code §330 generally authorizes the Secretary of the Treasury to “regulate the practice of representatives of persons before the Department of the Treasury.”
2. The Treasury regulations adopted pursuant to the foregoing provision are located in Title 31, Part 10, of the Code of Federal Regulations (Reg. §§10.1 to 10.93) and are informally known as Circular 230.

B. Event

1. On December 17, 2004, the Treasury Department published T.D. 9165, amending or adopting Reg. §10.33 (best practices for tax advisors), Reg. §10.35 (requirements for covered opinions), Reg. §10.36 (procedures to ensure compliance), Reg. §10.37 (requirements for written advice), Reg. §10.38 (establishment of advisory committees), and Reg. §10.52 (violation of regulations).

2. The changes to Circular 230 are generally effective after June 20, 2005.

C. Content

1. Overview. The Circular 230 amendments include very strict rules relating to so-called “covered opinions.” There are several categories of covered opinions, some of which are very broad. If a written communication constitutes a covered opinion, the practitioner must comply with strict standards regarding comprehensive evaluation and recitation of factual assumptions and representations and must evaluate all pertinent tax issues. In order to avoid these quite onerous requirements, an otherwise covered written communication must prominently state that the taxpayer may not rely on the communication to avoid penalties.

2. Definition of “Covered Opinion”

   a. A covered opinion is generally any “written advice” that falls in any of the following defined categories: (i) reliance opinions; (ii) marketed opinions; (iii) confidential opinions; and (iv) opinions that are subject to contractual protection.

   b. “Written advice” includes “electronic communications,” i.e., email.
c. Clearly, the most common form of covered opinion is the “reliance opinion.”

d. Written advice constitutes a “reliance opinion” if the advice concludes at a confidence level of more likely than not (i.e., a greater than 50-percent likelihood) that one or more significant federal tax issues would be resolved in the taxpayer’s favor if challenged by the IRS. Arguably, any written communication that sets forth a legal conclusion using words like “is,” “will,” or “should” will satisfy this standard.

e. Written advice is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

f. In order to be considered “prominently disclosed,” the foregoing disclaimer “must be set forth in a separate section at the beginning of the written advice in a bolded typeface that is larger than any other typeface used in the written advice.”

3. **Requirements for Covered Opinions**

a. The practitioner must use reasonable efforts to identify and ascertain the facts.

b. The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events).

c. The practitioner must not base the opinion on any unreasonable factual representations.

d. The opinion must identify in a separate section all factual assumptions and factual representations relied upon by the practitioner.

e. The opinion must evaluate all significant federal tax issues.
f. The opinion generally “must provide the practitioner’s conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the opinion.”

g. In evaluating the significant federal tax issues addressed in the opinion, the practitioner may 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.

h. Note: A rule is provided under which a practitioner may give a limited scope opinion.

4. **Requirements for Written Advice.** In the case of written advice that does not rise to the level of a “covered opinion,” the practitioner still is bound by the following rules:

   a. The practitioner may not base the advice on unreasonable factual or legal assumptions (including assumptions as to future events);

   b. The practitioner may not unreasonably rely upon representations, statements, findings, or agreements of the taxpayer or any other person;

   c. The practitioner must consider all relevant facts that the practitioner knows or should know, or, in evaluating a federal tax issue;

   d. The practitioner may 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.

5. **Practical Considerations**

   a. *Practitioners should be wary of violating these rules inadvertently.* It will be very easy to violate these rules when providing advice by email to clients in response to questions received by email or voice mail.

   b. *Important safety valve:* Written advice does not constitute a “reliance opinion” (the most common type of covered opinion) unless it involves “significant Federal tax issues.” The Circular 230 amendments provide that a federal tax issue “is significant if the Internal Revenue Service has a
reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.” Therefore, email messages that answer “no brainer” questions or simply recite well-settled law generally should not be treated as reliance opinions.

c. Practitioners would be well-advised to develop the habit of considering whether each written communication to a client is a “reliance opinion.”

d. Practitioners should develop standard disclaimer language for written advice that is not intended to constitute a reliance opinion. Law firms should consider developing procedures for determining when inclusion of such disclaimer language in a written communication is appropriate.

XIII. TREATMENT OF PAYMENTS AS WAGES


1. Background. In Rev. Rul. 58–145, 1958–1 C.B. 360, the IRS ruled that a bonus paid by a baseball club to an individual solely for signing the individual’s first contract and not in any way contingent on the performance of subsequent services is not remuneration for services and, therefore, does not constitute “wages” for purposes of federal income tax withholding.


3. Content


b. Rev. Rul. 2004–109 considered two situations. In the first situation, a baseball club paid a signing bonus to a new player contingent only on the player reporting for spring training at the time and place directed by the club. The contract provided that the signing bonus was not contingent on
the player’s future performance of services. In the second situation, an employer signed a collective bargaining agreement with a union under which each covered employee was entitled to receive an identical bonus on the ratification date, without regard to the performance of any future services by the employee.

c. The ruling set forth the following new “rule,” which the IRS apparently will apply uniformly in analyzing “wage” issues in the future:

   Employment encompasses the establishment, maintenance, furtherance, alteration, or cancellation of the employer-employee relationship or any of the terms and conditions thereof. If the employee provides clear, separate, and adequate consideration for the employer’s payment that is not dependent upon the employer-employee relationship and its component terms and conditions, the payment is not wages for purposes of FICA, FUTA, or Federal income tax withholding.

d. In both situations presented in the ruling, the IRS naturally concluded that the employee(s) had not provided separate consideration for the payment that was not dependent on the employer-employee relationship. Therefore, the IRS concluded:

   Amounts an employer pays as bonuses for signing or ratifying a contract in connection with the establishment of the employer-employee relationship are wages for purposes of FICA, FUTA, and Federal income tax withholding. Accordingly, the payments in Situations 1 and 2 are wages for purposes of FICA, FUTA, and Federal income tax withholding.


1. **Background**

   a. In Rev. Rul. 55–520, 1955–2 C.B. 393, the IRS ruled that an amount paid by an employer to a terminated employee, to settle a dispute arising out of the employer’s early cancellation of the employee’s two-year employment contract, did not constitute “wages” for FICA and federal income tax withholding purposes.
b. Similarly, in Rev. Rul. 58–301, 1958–1 C.B. 23, the IRS ruled that a lump sum payment received by an employee as consideration for his voluntary agreement to cancel the remaining period of a five-year employment contract during the second year of the term and to relinquish his contract rights was not subject to FICA or federal income tax withholding.

c. In Rev. Rul. 75–44, 1975–1 C.B. 15, an employer made a payment to an employee as consideration for the employee’s agreement to refrain from asserting seniority rights that the employee had acquired pursuant to his past service under an employment contract. The IRS ruled that the payment received by the employee constituted “wages” for purposes of federal income tax withholding. Rev. Rul. 75–44 distinguished Rev. Rul. 58–301 on the ground that, in Rev. Rul. 58–301, the lump sum payment was primarily in consideration of the cancellation of the employee’s original contract rights, while in Rev. Rul. 75–44, the payment was indirectly in consideration of the past performance of services through which the employee acquired the relinquished seniority rights.


3. **Content**

   a. The ruling considered the following fact situation:

      “An employee performs services under a written employment contract providing for a specified number of years of employment. The contract does not provide for any payments to be made by either party in the event the contract is cancelled by mutual agreement. Before the end of the contract period, the employee and the employer agree to cancel the contract and negotiate a payment from the employer to the employee in consideration for the employee’s relinquishment of his contract rights to the remaining period of employment.”

   b. As in Rev. Rul. 2004–109, described above, the IRS concluded that the contract termination payment constituted “wages,” reasoning that the employee had not provided consideration for the payment that was not
related to the employer-employee relationship. Following is the conclusion stated in the ruling:

Under the facts presented in this ruling, the employee receives the payment as consideration for canceling the remaining period of his employment contract and relinquishing his contract rights. As such, the payment is part of the compensation the employer pays as remuneration for employment. The employee does not provide clear, separate, and adequate consideration for the employer’s payment that is not dependent upon the employer-employee relationship and its component terms and conditions. Thus, the payment provided by the employer to the employee is wages for purposes of FICA, FUTA, and Federal income tax withholding.
NOTES