INTRODUCTION TO TAXATION

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FIFTH EDITION

2012 Supplement

William D. Popkin
Walter D. Foskett Professor Emeritus of Law
Indiana University at Bloomington School of Law

Originally Published as
Fundamentals of Federal Income Tax Law

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121 Chanlon Road, New Providence, NJ 07974
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200
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(Pub. 870)

TABLE OF CONTENTS

Chapter 1

TAX BASE, TAX RATES, AND TAXABLE UNITS

Numerous provisions in this chapter (and throughout this book) were contained in a 2001 Tax Law, often referred to as the Bush Tax Cuts because they were a major feature of the President's political agenda. Most of the tax breaks in this law (lower tax rates, deductions, and credits) were slated to expire at the end of 2010. Their extension beyond 2010 has been a political hot potato—with Republicans generally favoring permanent tax cuts and the Democrats generally favoring the elimination of tax breaks for married taxpayers with more than $250,000 of income. After the November 2010 election, a compromise was reached to extend most of the tax breaks for everyone through 2012 (sometimes only 2011)—in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) (referred to as the "2010 Tax Relief Act"). These extensions will be noted throughout this book.

§ 1.01 Tax Base

[B] Types of Deductions

Pages 5-6, add the following

1. The election to take an itemized deduction for state and local general sales taxes instead of income taxes (in **§ 164(b)(5)**) has been extended through 2012.

2. The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) allowed a taxpayer to deduct sales and excises taxes on the purchase of certain new motor vehicles on or before December 31, 2009. **§ 63(c)(1)(E)**. The deduction was phased out as modified adjusted gross income (MAGI) exceeded a certain threshold amount. This provision is no longer in the law and is noted here as one of many examples of using the tax law to stimulate selected economic activity.

[D] Inflation Adjustments

Page 6

The following are the inflation-adjusted figures for tax year 2012.

Standard deduction:

Single individual	$ 5,950
Married couple, filing jointly	11,900
Head of household	8,700

Personal exemption deduction: $ 3,800

§ 1.02 Tax Rates

[A] Progressivity; Marginal Tax Rates

Page 7

The following are the inflation-adjusted figures for tax year 2012.

Taxable income		Tax rates
Married-file jointly	Single	
> 388,350	> 388,350	35%
> 217,450 to 388,350	> 178,650 to 388,350	33%
> 142,700 to 217,450	> 85,650 to 178,650	28%
> 70,700 to 142,700	> 35,350 to 85,650	25%
> 17,400 to 70,700	> 8,700 to 35,350	15%
Not over $17,400	Not over 8,700	10%

If the 2001 Tax Law had been allowed to expire after 2010, the tax rates would have reverted to the following: 39.6%, 36%, 31%, 28%, 15%.

Relief from the marriage tax penalty for income subject to the 15% tax rate has been provided by making the top of the 15% bracket for a married couple twice the top of the 15% bracket for a single taxpayer (70,700 = 2 times 35,350). Absent this provision, the inflation-adjusted top of the 15% bracket for a married couple would be less than twice the top of the 15% bracket for a single taxpayer.

Pages 8-11, delete [C] "Phantom" Marginal Tax Rates

The discussion in this section is now out-of-date because the disappearance of the personal exemption and itemized deductions as income rises has expired—although the expiration is effective only through 2012. However, there are still phantom tax rates in the code, usually resulting from the loss of a tax credit as income rises. This is illustrated below in the discussion of the earned income credit.

Another phantom tax rate applies to corporations and is still in the law. They lose the benefit of the lower tax rates below the top tax rate as income rises above certain thresholds. **Sec. 11(b)(1) (flush paragraph)**.

Replace [C] with the following

[C] Medicare Tax on "Unearned" Income

Social Security taxes to fund benefits for the aged and disabled and to pay for Medicare are discussed in Chapter 28. But it is important to note one tax added by the Patient Protection and Affordable Health Care Act (Public Law 111-148) to help fund Medicare. This tax, which goes into effect in 2013, applies to "unearned income." This term refers to investment income, such as interest (not counting the tax exempt interest on state and local bonds), dividends, capital gains, royalties and rents, unless any of these items is derived from a trade or business. ("Unearned" contrasts with "earned," which refers to employee wages and self-employment income.)

The tax is 3.8% of the lesser of (1) net investment income or (2) modified adjusted gross income in excess of $200,000 for an individual and $250,000 for a married couple. These threshold amounts reflect President Obama's pledge not to raise taxes on individuals with lesser amounts of

income. For example, assume an individual has $180,000 of wages, $45,000 of unearned income, and modified adjusted gross income of $215,000. The 3.8% tax would be imposed on $15,000 (the lesser of $215,000 minus $200,000; and $45,000).

§ 1.03 Deduction for Dependents

[A] Dependent Children and the Taxable Unit

Page 11, add the following

The $750 figure used to compute the standard deduction of a dependent child and to compute the kiddie tax, and the $250 figure used to compute the standard deduction of a dependent child, are both adjusted for inflation. For tax year 2012, the figures are **$950** and **$300** respectively (unchanged from 2011).

§ 1.04 Married Units

Page 20, add the following

Statute of limitation; Statutory interpretation. **§ 6015(f)** gave rise to an interesting statutory interpretation issue in Lantz v. Commissioner, 607 F.3d 479 (7th Cir. 2010), reversing, 132 T.C. 131 (2009). The statute—in **§ 6015(b) & (c)**—explicitly required filing for innocent spouse relief within two years of the IRS' first collection action, but **§ 6015(f)** was silent on a filing date. Nonetheless, a Treasury regulation implementing **§ 6015(f)** stated that the taxpayer had to file for innocent spouse relief within two years. The Tax Court refused to follow the Regulation because of the contrast between the explicit statutory limitation periods in **§ 6015(b) & (c)** and silence in **§ 6015(f)**. On appeal, Judge Posner held for the government.

> [We do] not accept "audible silence" as a reliable guide to congressional meaning. "Audible silence," like Milton's "darkness visible" or the Zen *koan* "the sound of one hand clapping," requires rather than guides interpretation. Lantz's brief translates "audible silence" as "plain language," and adds (mysticism must be catching) that "Congress intended the plain language of the language used in the statute." . . .
>
> Agencies, [] being legislative as well as adjudicatory bodies, are not bashful about making up their own deadlines. And because they are not bashful, and because it is as likely that Congress knows this as that it knows that courts like to borrow a statute of limitations when Congress doesn't specify one, the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision. Whether the Treasury borrowed the two-year limitations period from subsections (b) and (c) or simply decided that two years was the right deadline is thus of no consequence; either way it was doing nothing unusual.

Judge Posner added a policy argument: "[I]f there is no deadline in subsection (f), the two-year deadlines in subsections (b) and (c) will be set largely at naught because the substantive criteria of those sections are virtually the same as those of (f)."

Despite the government victory in Lantz, the Treasury and IRS have decided "that individuals who request equitable relief under section 6015(f) will no longer be required to submit a

request for equitable relief within two years of the IRS's first collection activity against the requesting spouse with respect to the joint tax liability." IRS Notice 2011-70.

§ 1.05 Earned Income Credit

Pages 20-22, add the following (dealing, primarily, with inflation adjustments)

The EIC is 45% for taxpayers with three or more children (through 2012).

The inflation-adjusted amounts for the earned income credit for tax year 2012 are as follows. The figures include an upward adjustment to the phase-out threshold for married couples adopted by the American Recovery and Reinvestment Act of 2009 (the Obama stimulus law).

Earned income base amount:	
No children	$ 6,210
One child	9,320
More than one child	13,090

Phase-out thresholds:	
Married, filing jointly:	
No children	$ 12,980
One or more children	22,300
Other taxpayers:	
No children	$ 7,770
One or more children	17,090

Notice that a married couple has a higher phase-out threshold than a single taxpayer. As the text notes, the increase in the phase-out threshold was $3,000 in 2008 (adjusted for inflation). This amount was later increased to $5,000 (adjusted for inflation) and this $5,000 increase has been extended through 2012.

For 2012 the inflation-adjusted amount of disqualified income above which the EIC is denied equals **$3,200**.

The provision for an advance payment of the EIC by an employer to an employee has been repealed beginning in 2011.

Page 22, add the following (dealing with the "phantom tax rate")

A phantom tax rate occurs when the increase in tax resulting from an increase in income is higher than the stated tax rate in sec. 1 times the income. For example (using some made up numbers), if someone is in the 30% bracket and earns $10,000, you would expect a $3,000 increase in taxes—because $3,000 is 30% of $10,000. But suppose a $10,000 increase in income causes the taxpayer to have more than $10,000 of taxable income (because some deduction is lost) or the $10,000 of income results in the loss of a tax credit. In that case, the $10,000 of income will result in more than a 30% increase in tax.

For example (again, using some made up numbers), assume that $10,000 of income results in the loss of a $300 credit that would otherwise have reduced the tax. For someone in the 30% bracket (as specified in sec. 1), the tax goes up by $3,000 plus $300; and a $3,300 increase in tax will appear to the taxpayer as a 33% tax on $10,000 of income.

The earned income credit produces a phantom tax rate. For example, in 2011, for a married couple with one child and with earned income of $31,770 (which also equals adjusted gross income), the earned income credit of $3,094 (34% times $9,100), is reduced by 15.98% of the income over the phase-out threshold of $21,770. That reduction equals $1,598. In other words, income of $10,000 results in whatever tax results from applying the sec. 1 rates *plus* $1,598. Assuming the taxpayer was in the 15% bracket (as provided by sec. 1), the result (in effect) is a 31.98% tax rate on the income earner. You may be startled to learn that low income earners confront an effective tax rate around 30%, which approaches what a married couple with more than $200,000 of income would pay.

This phantom tax rate applies over a phase-out range. Using 2011 numbers for a married couple with one child, the phase out range for the earned income credit is between $21,770 and $41,132. That is, excess income of $19,362 (41,132 minus 21,770) results in a loss of $3,094 in the tax credit, wiping out the tax credit completely. Once the top of the phase out range has been reached, the sec. 1 rates again become the operative tax rates, unless (of course) there is another phantom tax rate resulting from the loss of some other tax break as income exceeds $41,132.

§ 1.06 Child Tax Credit

Pages 22-23, add the following

The $1,000 child tax credit has been extended through 2012.

The amount of the refundable child tax credit has been continuously increased. The basic law states that the refund equals 15% of the excess of earned income over a sum that is adjusted for inflation—a sum that has been twice lowered. The refundable credit now equals 15% of earned income in excess of $3,000, but without an inflation adjustment—extended through 2012.

§ 1.09 Recovery Rebate Credits

Page 25, delete this section

§ 2.04 Domestic Partners

Page 32, add the following

In a 2010 Private Letter Ruling (201021048), the IRS struck a very different tone from the Chief Counsel Advisory 200608038 in the text. It described California law as follows:

> In 2005, California law significantly expanded the rights and obligations of persons entering into a California domestic partnership for state property law purposes, but not for state income tax purposes. Specifically, the California Domestic Partner Rights and Responsibilities Act of 2003 (the California Act), effective on January 1, 2005, provided that "Registered domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law . . . as are granted to and imposed upon spouses." However, the California Act provided that "earned income may not be treated as community property for state income tax purposes."
>
> On September 29, 2006, California enacted Senate Bill 1827. Senate Bill 1827 repealed the language of the California Act providing that earned income was not to be treated as community property for state income tax purposes. Thus, effective January 1, 2007, the earned income of a registered domestic partner (RDP) must be treated as community property for state income tax purposes (unless the RDPs execute an agreement opting out of community property treatment). As a result of the legislation, California, as of January 1, 2007, treats the earned income of registered domestic partners as community property for both property law purposes and state income tax purposes.

The ruling then applies California property law to determine federal income tax consequences without regard to whether the law deals with traditional marriage relationships.

> California community property law developed in the context of marriage and originally applied only to the property rights and obligations of spouses. The law operated to give each spouse an equal interest in each community asset, regardless of which spouse is the holder of record.
>
> By 2007, California had extended *full community property treatment* to registered domestic partners. Applying the principle that federal law respects state law property characterizations, the federal tax treatment of community property should apply to California registered domestic partners. Consequently, for tax years beginning after December 31, 2006, a California registered domestic partner must report one-half of the community income, whether received in the form of compensation for personal services or income from property, on his or her federal income tax return.

Chapter 3

DEFINING INCOME

§ 3.04 Capital Gains Preference

[B] History of Preferential Treatment

Page 47, add the following

In 2010, dividends were eligible for the same low tax rates as capital gains—generally 15% (lowered to 0% if the dividends would otherwise be taxable at the 10% or 15% ordinary rates). The 2010 Tax Relief Act extends this tax break for both dividends and net capital gains through 2012.

§ 3.06 What is Income—Accession to Wealth

[A] From "Sources" to "Accession to Wealth"

[2] Note on Statutory Interpretation

[d] General Welfare Exclusion

Page 59, add the following

The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) excluded from gross income the first $2,400 of Unemployment Insurance for 2009—but this tax break has expired.

[3] Dominion and Control

Page 60, add the following

3. In Private Letter Ruling 200722005, the IRS held that the following payments to property owners were not taxable—both because of a lack of a dominion and control and, in one instance, under the general welfare exclusion.

> The City has an easement or other property interest over driveway approaches, which include the sidewalks, curbs, and gutters within driveways. Accordingly, the City shares with property owners the responsibility of maintaining driveway approaches. As a rehabilitation incentive, the City implemented the Program to reimburse the costs of replacing existing driveway approaches, including sidewalks, curbs, and gutters within driveways, that are deteriorated, broken, and/or hazardous, as determined by the Department. . . .
>
> Under the Program, the City generally reimburses property owners a maximum of 50 percent of rehabilitation cost. In order to receive the reimbursement, applicants must (i) own properties that are located within the City and (ii) comply with the Program procedure . . . . In certain cases, the City reimburses 100 percent of the rehabilitation cost. Full reimbursement is made if applicants (i) meet the

requirements for the 50 percent reimbursement, (ii) are owners of primary residences, and (iii) are qualified senior citizens or disabled persons. To be considered qualified senior citizens or disabled persons, homeowners must provide proof that they are either (i) 62 years of age or older and meet income and asset limitations, or (ii) certifiably disabled.

[The ruling cites the Bailey case for the exclusion of government grants over which the taxpayer lacked dominion and control. It also cites several revenue rulings explaining the general welfare exclusion—Rev. Rul. 76-395, 1976-2 C.B. 16 (payments made to low income individuals primarily in order to subsidize home improvements necessary to correct building code violations and thereby provide safe and decent housing were excluded from the recipients' income under the general welfare exclusion.); Rev. Rul. 76-131, 1976-1 C.B. 16 (payments made by the State of Alaska to long-term residents were not excluded by the general welfare exclusion because the payments were based on the recipient's age and residency requirements, regardless of financial or employment status, health, or educational background).]

In this case, property owners lack complete dominion and control over their driveway approaches, which are subject to a public right-of-way. In addition, the City substantially controls the rehabilitation work; it must pre-approve the rehabilitation work and post-inspect the work before any payments are made to the contractors. Accordingly, the reimbursements are not income to the property owners.

Furthermore, even assuming the 100 percent reimbursements made by the City to qualified senior citizens or disabled persons can be said to reimburse these property owners for their share of maintenance responsibility, the additional reimbursement is excluded from gross income under the general welfare doctrine. The Program makes reimbursements from a governmental fund, the additional reimbursement is based on age and financial need or disability, and the reimbursements do not represent compensation for services.

[C] Discharge of Indebtedness

[1] Defer Taxation of Income; Basis Adjustment

[b] Solvent Debtors

Page 69, add the following

The exclusion from income for discharge of indebtedness income related to a principal residence is extended through 2012.

The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) adds **§ 108(i)**, which provides an election to defer income from the discharge of business indebtedness (without regard to eligibility under any other statutory provision) arising from the reacquisition of a debt by a C corporation (that is, any corporation taxed as a separate entity) or by any other taxpayer in connection with the conduct of a trade or business—that is, typical mortgage lenders. This provision applies to a reacquisition occurring during 2009 and 2010 (not extended beyond 2010). The income must be reported over a five year period beginning in 2014.

Page 70, add the following

[d] Discharge of Indebtedness for Interest

The rationale for including discharge of indebtedness in income is that the loan proceeds provided the taxpayer with an increase in wealth that will not be offset by repayment of debt, once the debt is forgiven. In effect, the debt forgiveness means that there is an accession to wealth. This often occurs when the taxpayer borrowed cash that was not taxed at the time of the loan or took a deduction for an investment funded by the loan. How does that rationale apply when the debt that is forgiven is for interest on a consumer loan?

The interest obligation enables the taxpayer to enjoy personal consumption earlier than would otherwise be the case—that is, earlier than if the taxpayer had waited until there was income at a later date. Does that debt provide the kind of accession to wealth that should be included in income if the debt is not paid? Chapter 3.08 discusses the tax treatment of interest. It suggests that the characterization of interest as an accession to wealth depends on whether the tax law adopts an income tax or consumption tax approach.

The income tax (unlike a consumption tax) favors current over future consumption—because it taxes income used for savings *and* the income earned on those savings, whereas the consumption tax defers tax until future consumption occurs. However, the fact that the income tax does *not* allow a deduction for interest on consumer loans tilts in the opposite direction—because disallowing the interest deduction does *not* favor current over future consumption. In other words, the current income tax adopts a consumption tax model for consumer loans when it disallows the deduction of consumer loan interest. This suggests that the discharge of an obligation to pay interest on a consumer loan *is* income, because that result means that current consumption is *not* favored over future consumption.

In this connection, note **§ 108(e)(2)**, which states that "no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction." This means that forgiveness of an interest debt would not result in income if the interest was deductible. Does it also mean that the converse is true—requiring the taxation of debt forgiveness if the interest is not deductible?

§ 3.08 Appendix—Comparison of Income Tax and Consumption Tax

[B] Loan

[2] Comparison of Income Tax and Consumption Tax

[c] Loans Not taxable; Repayment of Loan Not Deductible; Interest Deductible

Page 79, correction

The ratio of Year 1/Year 2 is **10/10.5**. The text incorrectly states that the ratio is 10/11.

Chapter 4

GIFTS

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§ 4.04 Death

[D] Basis: 2010 and Beyond

Pages 86-87, delete current subsection and replace with the following

The 2001 Tax Law increased the estate tax exemption and lowered the estate tax rates until there was no estate tax in 2010. The 2010 Tax Relief Act did not extend the 2010 abolition of the estate tax but still modified the rules in a way favorable to taxpayers through 2012. The exemption is $5 million (indexed for inflation after 2011). The maximum tax rate is 35%. Because these is still a potential estate tax, the date-of-death-value-as-basis rules still apply, without any of the complications (explained in the text) that applied in 2010.

For 2010, a decedent's estate can elect between the new rules (with stepped-up basis) or the rules in the 2001 Tax Law that eliminated the estate tax for 2010 with (under some circumstances) a carryover basis.

[E] Gift Tax

Page 87, delete this section and replace with the following

There is a gift tax on lifetime transfers. The 2010 Tax Relief Act integrates the gift and estate tax. In other words, a $2 million lifetime gift is eligible for a total $5 million exemption, leaving a $3 million exemption for gifts at the time of death. (The 2001 Tax Law allowed only a $1 million dollar gift tax exemption, regardless of the rules applicable to an estate.)

The gift tax exemption should not be confused with the annual per donee gift tax exclusion—which is $13,000 in 2012 (adjusted for inflation). This exclusion applies to cash gifts of a present interest (not gifts in trust). Thus, a cash gift of $15,000 uses up the $13,000 exclusion, leaving $2,000 to be debited against the $5 million exemption. (The donor must file a return to claim an exemption, but not the exclusion.) The exclusion applies to each donor and donee, so that a husband and wife can give a total of $52,000 cash each year to their two children.

Chapter 5

TAXABLE YEAR

§ 5.05 Income Averaging

Page 106, add the following

Compensation paid to victims of the Exxon Valdez oil spill are eligible for the three-year income averaging provision in **§ 1301.** This provision appears in **§ 504(a)** of the Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

Chapter 6

LEGISLATIVE PROCESS, ADMINISTRATIVE RULEMAKING, THE ADJUDICATION SYSTEM, AND PROFESSIONAL ETHICS

§ 6.01 Legislative Process

[C] The Problem of Tax Expenditures

[3] Efficiency and Progressive Rates

Page 113, add the following

The exemption for interest does not apply to state and local bonds guaranteed by the federal government. **§ 149(b)(1)**. This could have had serious implications during the financial crisis that began in the fall of 2008, if financially shaky state and local governments had sought a federal guarantee for their obligations.

Pages 118-124

Delete § 6.02 and replace with the following

§ 6.02 Agency Rulemaking

[A] Regulations

Introduction. You always start with the statute to determine tax law, but agency rules play a significant role in determining what the statute means. In general, Regulations are at the top of the rulemaking ladder, followed by Revenue Rulings. These and other agency rules are discussed in this section. The major players in the administrative rulemaking process work in the Internal Revenue Service (headed by the Commissioner), the Office of the Chief Counsel to the Internal Revenue Service, and the Office of the Assistant Secretary of the Treasury for Tax Policy.

In conventional administrative law, a distinction is made between substantive and interpretive regulations. A substantive regulation is issued pursuant to an explicit grant of regulatory authority in the governing statute. An interpretive regulation interprets the law without any explicit grant of statutory authority — e.g., when the meaning of a word is unclear. It is uncertain whether the general grant of regulatory authority in **§ 7805(a)** (giving the Secretary the power to ``prescribe all needful rules and regulations'' to enforce the law) is a grant of substantive or interpretive rulemaking authority.

Under the Administrative Procedure Act (APA), substantive regulations must be issued after notice to the public and an opportunity for public comment. However, the APA does not impose these requirements for interpretive regulations. Regulations issued under **§ 7805(a)** are probably substantive regulations under the APA – because they are intended to have the force of law -- whether or not they are considered substantive or interpretive regulations under the Internal Revenue Code. As a practical matter, the difference between substantive and interpretive regulations is often not meaningful under the income tax law because the Treasury usually uses public notice and comment procedures, regardless of what the law requires. The quality of the

procedures used in promulgating income tax regulations makes them the most authoritative agency interpretation of the tax law. They not only follow a public notice and comment procedure but are also signed by both administrative and tax policy officials (the Commissioner and the Assistant Secretary of the Treasury for Tax Policy).

A major exception to the practice of issuing tax regulations after public notice and comment is the practice regarding temporary regulations. These regulations are issued without public notice and comment. Under **§ 7805(e)**, temporary regulations must be accompanied by the issuance of proposed regulations with an opportunity for notice and comment and the temporary regulations must expire in three years. Proposed Regulations are published in the Federal Register and final regulations appear in the Code of Federal Regulations (C.F.R.).

Let us first consider whether regulations issued with notice and comment are authoritative and then examine the authority of temporary regulations.

Regulations issued with notice and comment. Regulations issued after notice and comment are authoritative, but what does that mean? The conventional administrative law answer is given by *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), which holds that the court should defer to a regulation if the statute has not resolved an issue and the agency interpretation is reasonable. There are two slightly different ways to describe when Congress has failed to resolve an issue -- when the statute has left a gap for an agency to fill or Congress has delegated authority to the agency. Perhaps there is a "gap" when language is unclear even though it is difficult to infer a delegation of authority from anything else the statute might say. In *United States v. Mead Corp.*, 533 U.S. 218 (2001), the Court made it clear that the gap can be created either expressly (by an express textual delegation of authority) or implicitly ("from the agency's generally conferred authority and other statutory circumstances [indicating] that Congress would expect the agency to be able to speak with the force of law").

In tax cases, there were doubts whether *Chevron* deference should be accorded to both substantive and interpretive tax regulations until the Court decided *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011). This case dealt with a Treasury Department rule interpreting the Social Security Act. That Act exempted from taxation "service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." The Treasury regulations exempted students whose work was "incident to and for the purposes of pursuing a course of study." In 2004, the Treasury replaced its case-by-case application of this standard with a rule that categorically excludes from the student exemption a "full-time employee," defined in all events as an employee "normally scheduled to work 40 hours or more per week." The issue was whether this regulation could be applied to deny an exemption for medical residents who have graduated from medical school and train for a specialty. These doctors are required to engage in formal educational activities but spend most of their time (50 to 80 hours per week) caring for patients. The Court concluded that Congress had not directly addressed this precise question because it did not define "student" or consider how to deal with medical residents.

The Court noted that it had sometimes relied in tax cases on the *National Muffler* case, 440 U.S. 472, which had been skeptical of regulations that were inconsistent over time, were issued long after the law was enacted, or were a response to litigation. Those of you familiar with administrative law will recognize *National Muffler* as an application of what is referred to as *Skidmore* deference, named after *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). Under Skidmore, the courts look at the agency's care in reasoning, its consistency in sticking to its rules, the longstanding nature of the rule,

the formality of its rulemaking procedures (such as following notice and comment procedures), its expertise, and "all those factors which give power to persuade, if lacking power to control."

In *Mayo* the Court concluded that Chevron deference did not depend on the factors mentioned in *National Muffler* and it then deferred to the Treasury's Regulation. In reaching its conclusion, the Court made no distinction between rules issued pursuant to the Treasury Department's general authority to "prescribe all needful rules and regulations for the enforcement" of the tax law (that is, regulations that might be considered interpretive issued under **§ 7805(a)**) and rules "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision" (that is, "substantive" regulations). The Court also noted that the Treasury Department had "issued the [] rule only after [public] notice-and-comment procedures, again a consideration identified in our precedents as a 'significant' sign that a rule merits *Chevron* deference."

No notice and comment. It should be obvious from this discussion that there are APA concerns and *Chevron* deference issues whenever rules are issued without notice and comment. In the tax context, this problem arises with Temporary Regulations (and with Revenue Rulings, discussed below). In Intermountain Insurance Service v. Commissioner, 134 T.C. 211 (2010), a *concurring* opinion argued that a tax regulation is "substantive," subject to the APA requirements of public notice and comment, whenever "Congress has given the agency authority to issue rules with the force of law and the agency intended to use that authority." (It did not matter that, under tax law, these regulations might be considered "interpretive.") Consequently, the concurring opinion argued, the temporary regulation was invalid under the APA because of a failure to provide public notice and comment.

Under the APA, a later statute can override APA rules if it does so "expressly" – "no subsequent legislation shall be held to supersede or modify the provisions of this Act except to the extent that such legislation shall do so expressly;" 5 USC § 559. The concurring opinion in *Intermountain* rejected the argument that **sec. 7805(e)** amounted to an "express" override of the APA requirement as follows:

> The legislative history of [sec. 7805(e)] shows that Congress was aware of the Secretary's procedures of issuing temporary regulations that were effective immediately but without notice and comment. [The Commissioner] says that Congress implicitly okayed that process by limiting the temporary regulations to 3 years and ensuring that the Secretary issued an NPRM at the same time. Even though this violates the APA, he justifies it by arguing that section 7805(e) conflicts with the APA, and in the battle of the statutes, a specific statute trumps a general one.
>
> We do not agree. First we note that nothing in the text of the statute suggests that the notice-and-comment requirement has been waived, nor does the legislative history state that it has. The legislative history does note that the Secretary commonly issued temporary regulations with immediate effect, but this alone hardly suggests Congress meant to waive notice and comment for all temporary regulations. The legislative history does not even mention the APA, and both the Supreme Court and the APA itself provide that exceptions to the APA's terms cannot be inferred -- much less inferred from an absence in the legislative history . . . . [The Commissioner] may think that

> section 7805(e) makes him special when it comes to rulemaking, but the APA makes it clear that he is not.

The Court of Appeals in *Intermountain*, 650 F.3d 691 (D.C.Cir. 2011), was more accepting of the result achieved by the Temporary Regulation because it was followed by more or less identical final regulations issued after notice and comment within the required three year period. It relied on the judicially-developed "open-mind" doctrine, as follows:

> [Taxpayer argued that] the Commissioner failed to keep an "open mind" during the notice-and-comment period. . . . Here, the Commissioner simultaneously issued immediately effective temporary regulations and a notice of proposed rulemaking for identical final regulations and then held a 90–day comment period before finalizing the regulations. According to [taxpayer] that procedure, although typical of the Commissioner's practice, violates the Administrative Procedure Act, thus requiring an open-mindedness inquiry.
>
> . . . [W]e believe the final regulations were validly promulgated. [Taxpayer] criticize[s] the Commissioner for the preamble's "silen[ce] regarding the numerous arguments" advanced in voluminous related litigation, and for "ma[king] only immaterial changes" in response to those comments, But an open-mindedness review focuses not on whether the Commissioner responded to *litigants,* but rather on whether he has "afforded the *comments* [received during the comment period] particularly searching consideration." Moreover, "[w]hile changes and revision are indicative of an open mind, an agency's failure to make any does not mean its mind is closed." Here, the Commissioner received only one comment, which characterized the proposed regulations as having "retroactive effect 'in that taxable years which had closed are now reopened.'" Responding to this comment in the preamble to the final regulations, the Commissioner "disagreed with the characterization of the regulations as retroactive" and noted that "[t]he final regulations have been clarified to emphasize that they only apply to open tax years, and do not reopen closed tax years." This last response appears to mean that although the regulations apply to pending cases such as this one, they have no applicability to [other] cases in which the Commissioner lost and declined to appeal. The Commissioner also responded to the commenter's reliance on the 1996 amendments to section 7805(b), which prohibit the Commissioner from making certain regulations retroactive. Specifically, the Commissioner explained that those amendments have no applicability to the statutory provisions interpreted by the regulations and, in any event, that "these regulations are not retroactive." Given the Commissioner's "searching consideration" of the comment, we have no doubt that he kept the requisite open mind.

There is one more argument against applying the APA to at least some Temporary Regulations. 5 U.S.C. sec. 553(b)(B) provides an exemption from the APA for "good cause." In the tax context, this exemption might apply when a proposed regulation (not yet effective) would lead to undesirable behavior that tries to avoid the impact of any final regulation -- for example, when a proposed regulation stated that preferential capital gains treatment would no longer be available for specified transactions, thereby leading to a flood of "capital gains" transactions.

Remember Skidmore. Even if the rule is invalid under the APA for failure to meet notice and comment requirements and is, as a result, not entitled to *Chevron* deference, it might still be entitled to some weight under *Skidmore*. The same issue arises with Revenue Rulings, discussed below.

Retroactive Regulations. **Section 7805(b)(1)** provides that no Regulation (relating to laws enacted on or after July 30, 1996) shall apply retroactively (with some exceptions). The exceptions include regulations filed or issued within 18 months of enactment of the law to which the regulation relates; and any regulation which the Secretary of the Treasury provides is needed to prevent "abuse." However, this provision only applies to laws enacted on or after July 30, 1996 (Public Law 104-168, sec. 1101(b)). Whether or not the Treasury can adopt a Regulation retroactively when it is not subject to **§ 7805(b)(1)** remains an open question.

Regulation that helps a taxpayer. If the Regulation *helps* the taxpayer, there is no need for the taxpayer to invoke *Chevron*. The courts will not permit the agency to disavow the regulation retroactively, even if the government could not rely on the regulation to support the government's position. Retroactive revocation is an abuse of agency discretion. Consequently, the dispute over whether *Chevron* applies is relevant primarily when the government invokes the regulation.

[B] Revenue Rulings

[1] Can Taxpayers Rely on Revenue Rulings?

Revenue Rulings are usually published distillations of the contents of important letter rulings. (Letter rulings are discussed below.) They are almost always issued by the IRS without public notice and comment. They appear first in the Internal Revenue Bulletin and are then published semi-annually in the Cumulative Bulletin (C.B.).

The IRS says that taxpayers can generally rely on Revenue Rulings and that any new ruling will not generally be applied retroactively to the extent that it would have adverse effects on the taxpayer. Rev. Proc. 78-24, 1978-2 C.B. 502.

Courts have sometimes said that retroactive revocation of a Revenue Ruling is permitted, but there are strong hints that retroactive revocation might be disallowed as an abuse of agency discretion if the result would be unduly harsh. Dunn v. United States, 468 F. Supp. 991, 995 (S.D.N.Y. 1979). *See also* Estate of McLendon v. Commissioner, 135 F.3d 1017 (5th Cir. 1998) (the agency cannot depart from a Revenue Ruling in the taxpayer's favor, if the law interpreted by the ruling is unclear).

See also *Rauenhorst v. C.I.R.*, 119 T.C. 157 (2002), where the Tax Court forced the government to apply its own Revenue Ruling to benefit a taxpayer claiming a charitable contribution, stating:

> The Commissioner has neither revoked nor modified Rev. Rul. 78-197. … Indeed, the Commissioner has continued to rely on Rev. Rul. 78-197, in issuing his private letter rulings. … [W]e are not prepared to allow respondent's counsel to argue … against the principles and public guidance articulated in the Commissioner's currently outstanding revenue rulings. … [W]e cannot agree that the Commissioner is not bound to follow his revenue rulings in Tax Court proceedings. Indeed, we have on several occasions treated revenue

> rulings as concessions by the Commissioner where those rulings are relevant to our disposition of the case. … Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law. … The Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner's position in Rev. Rul. 78-197, 1978-1 C.B. 83, as a concession.

[2] *Chevron* Deference?

When the government relies on a Revenue Ruling as legal authority, courts once said that they carry no weight as interpretations of law — they are just the opinion of one of the litigants. Browne v. Commissioner, 73 T.C. 723, 731 (1980) (Hall, J., concurring). More recently, some courts have applied *Chevron* deference to Revenue Rulings and there is considerable uncertainty as to whether that is appropriate and whether it is good law. See, e.g., *Bankers Life and Casualty Co. v. United States*, 142 F.3d 973 (7th Cir. 1998), which states:

> Revenue rulings receive the lowest degree of deference — at least in this circuit. In First Chicago, we held that revenue rulings deserve ``some weight,'' and are ``entitled to respectful consideration, but not to the deference that the Chevron doctrine requires in its domain.'' In other circuits this question has generated inconsistent rulings ranging from Chevron deference to no deference.

In Ryan Lirette, *Giving* Chevron *Deference to Revenue Rulings and Procedures*, 129 Tax Notes 1357 (2010), the author notes that there is now a lower court consensus that Revenue Rulings and Revenue Procedures are only eligible for *Skidmore* (not *Chevron*) deference. But the author advocates *Chevron* deference for these rulings if "Congress would have wanted [them] to receive *Chevron* deference," which (he argues) is often true. This would mean *Chevron* deference despite the absence of public notice and comment prior to issuing the rulings.

Supreme Court cases, dealing with nontax agencies, suggest some uncertainty about the level of deference to accord agency rules that do not go through a public notice and comment procedure (such as a Revenue Rulings): Raymond B. Yates v. Hendon, 541 U.S. 1 (2004) (*Skidmore* deference to a Department of Labor advisory opinion; Justice Scalia's concurrence argued for *Chevron* deference because the opinion was the agency's considered official view and was not "contrived for this litigation"); Alaska Dept. of Environmental Conservation v. E.P.A., 540 U.S. 461 (2004) (refusing *Chevron* deference to an internal guidance memoranda, but nevertheless giving it "respect"'; Kennedy's dissent argued that the "respect" had amounted to *Chevron* deference).

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The Department of Justice (DOJ) once argued that Revenue Rulings had the force of law under *Mead* and were therefore entitled to Chevron deference, but the appellate section chief of the DOJ announced at a May 2011 meeting of the American Bar Association Section on Taxation that the DOJ would no longer argue that revenue rulings should receive Chevron deference (Tax Notes, May 16, 2011, p. 674). Presumably the IRS can take a different position in litigation than the DOJ,

so the issue remains open. In this connection, what do you make of **Treas. Reg. § 601.601(d)(2)(v)(d)**, stating that "Revenue Rulings [] do not have the force and effect of Treasury Department Regulations [], but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied on for that purpose." Does "precedents" refer only to internal agency practice, or does it mean that Revenue Rulings can be cited in court to support an agency position?

In any event, the fact that Revenue Rulings are not issued with public notice and comment might make them invalid under the APA. Consequently, they might only be entitled to *Skidmore* deference on that account. See Leandra Lederman, The Fight Over "Fighting Regulations" and Judicial Deference in Tax Litigation, 92 Boston Univ. L. Rev. 643 (2012).

For scholarly comment on this issue, see Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51 (1996); Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 OHIO ST. L.J. 637 (1996); John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 GEO. WASH. L. REV. 35 (1995); Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 OHIO ST. L.J. 1037 (1995).

[3] Rulings Interpreting Regulations

Yet another wrinkle is the weight accorded to Revenue Rulings that explicitly interpret Treasury Regulations. Courts sometimes say that an agency interpretation of its own regulations is entitled to substantial deference. A recent tax case — U.S. v. Cleveland Indians Baseball Co., 532 U.S. 200 (2001) — is an example. The Court said:

> … [T]he Internal Revenue Service has consistently interpreted [the Regulations] to require taxation of back wages according to the year the wages are actually paid, regardless of when those wages were earned or should have been paid. Rev. Rul. 89-35, 1989-1 C.B. 280; Rev. Rul. 78-336, 1978-2 C.B. 255. We need not decide whether the Revenue Rulings themselves are entitled to deference. In this case, the Rulings simply reflect the agency's longstanding interpretation of its own regulations. Because that interpretation is reasonable, it attracts substantial judicial deference. Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994). We do not resist according such deference in reviewing an agency's steady interpretation of its own 61-year-old regulation implementing a 62-year-old statute. ``Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." Cottage Savings Ass'n v. Commissioner, 499 U.S. 554, 561 (1991) (citing *Correll*, 389 U.S., at 305–06).

Whether agency interpretations of its own regulations *should* receive substantial deference is not an easy question. If a court accords such deference, that could encourage the agency to adopt regulations in need of further interpretation, which is then provided by rulemaking procedures which do not provide the public with notice and an opportunity to comment. *See* Noah, *Divining Regulatory Intent: The Place for a ``Legislative History'' of Agency Rules*, 51 HASTINGS L.J. 255, 284–

90 (2000). Nonetheless, the Supreme Court has accorded agency interpretations of its own rules substantial deference; Auer v. Robbins, 519 U.S. 452 (1997).

In *Gonzales v. Oregon*, 546 U.S. 243 (2006), the Court imposed a qualification on the principle that an agency's interpretation of its own regulations deserves substantial deference. The Attorney General had issued an Interpretive Rule interpreting a Regulation. This Rule stated that assisted suicide was not a legitimate medical purpose and that prescribing a federally controlled substance for that purpose violated the federal Controlled Substances Act. The Court held that this Rule was not entitled to deference under *Auer v. Robbins* because the regulation which the Rule interpreted merely paraphrased the statutory language. And, in Talk America, Inc. v. Michigan Bell Telephone Co., 131.Ct. 2254, 2263 (2011), the Court explicitly noted that the agency's interpretation of its own regulation was not a "post-hoc rationalization [] of agency action under judicial review," rather than a "fair and considered agency judgment."

[4] Other Agency Rulings

There are a few other agency statements about the law.

1. Revenue Procedures usually deal with (not surprisingly) procedure — such as how returns should be filed. But sometimes they provide substantive guidance — such as explaining the multiple factors that go into reaching a substantive decision. See, e.g., two Revenue Procedures discussed in later chapters — Rev. Proc. 72-18, 1972-1 C.B. 740 (Chapter 16.02[A]; allocating interest on debt incurred to purchase or carry tax exempt bonds); Rev. Proc. 71-21, 1971-1 C.B. 549; Rev. Proc. 2004-34, 2004-1 C.B. 991 (Chapter 25.01[B][2][c][I]; deferring prepaid income). Revenue Procedures also state those areas of tax law where the government will not issue letter rulings (discussed below) — usually involving fact-specific issues or tax avoidance potential. Presumably, they are entitled to the same deference as Revenue Rulings.

2. The IRS will sometimes issue an acquiescence or nonacquiescence in a Tax Court decision (the Tax Court is discussed below). These statements tell taxpayers whether a decision will or will not be followed by the government. The government does not consider these statements to be precedent in other cases, so (presumably) they are entitled to little or no deference.

[C] Letter Rulings; TAMs

There are other forms of agency interpretations, which you will see cited throughout the course. A letter (or private) ruling is an administrative "declaratory judgment," which the National Office of the IRS will issue to a taxpayer for a fee. If the taxpayer has accurately described the facts and has relied on the ruling to plan future behavior, the agency promises that it will not revoke the ruling *as to that taxpayer*. Taxpayers cannot rely on a ruling issued to another taxpayer, although there are occasional cases holding that a taxpayer cannot be denied the benefit of a favorable ruling received by a competitor. IBM v. United States, 343 F.2d 914 (Ct. Cl. 1965). *But see* Florida Power & Light Co. v. United States, 56 Fed. Cl. 328 (2003) (limiting IBM case to taxpayers who have asked for a ruling providing the benefit received by a competitor), *aff'd*, 375 F.3d 1119 (Fed. Cir. 2004). *See also* Farmers' & Merchants' Bank v. United States, 476 F.2d 406 (4th Cir. 1973) (taxpayer-bank should be allowed same tax benefit as other banks who benefitted from an exception to a retroactive revocation of a Revenue Ruling).

Another type of agency interpretation, specific to a particular taxpayer, is a Taxpayer Advice Memorandum (TAM). Like a letter ruling, it is issued by the National Office of the IRS, but is a response to a request for legal advice by a field agent, not the taxpayer.

Letter rulings and TAMs are not officially published by the government but are available to the public under the Freedom of Information Act and **§ 6110** (with confidential information, including the taxpayer's identity, redacted). Because of the amount of money involved in taxation, private publishers (including Lexis and Westlaw) routinely publish most important letter rulings and TAMs, so that they are read by interested tax advisors.

The government's position is that letter rulings and TAMs are not precedent. Indeed, **§ 6110(k)(3)** states that they ``may not be used or cited as precedent," except as the government otherwise provides by Regulation. But the practice is more complex. See 88 TAX NOTES 1035 (2000). A longstanding practice of issuing letter rulings is likely to carry some weight with a court, especially if the reasoning of the rulings seems persuasive. And, in a recent case, the government asked the court to purge a judicial opinion of references to TAMs, but the court refused. Buckeye Power, Inc. v. United States, 38 Fed. Cl. 283 (1997):

> [The government] does not agree with the reasoning of the TAM referenced by the court and requests that it be deleted from the record. Defendant presents no evidence that Congress intended **I.R.C. § 6110(k)(3)** to shield all non-precedential decisions from use by the outside world. [Editor — The court states in a footnote: "It is worth noting that the government cites TAMs when the TAMs support its position."] [T]he purpose for the non-precedential status of TAMs is that if all publicly disclosed written determinations were to have precedential value, the Service would be required to subject them to considerably greater review than as provided under current procedures. Congress believed that the resulting delays in the issuance of determinations would mean that many taxpayers could not obtain timely guidance from the Service and the ruling program would suffer accordingly.
>
> **I.R.C. § 6110(k)(3)** permits the IRS to provide expeditious guidance to a single taxpayer, while preserving the opportunity to revisit its reasoning at a future time. However, the mere fact that TAMs are not binding on the IRS does not insulate the IRS from persuasive reasoning contained in prior decisions. Stated differently, strong analytical reasoning does not lose its persuasive force simply because the reasoning does not bind the IRS or constitute authority to be cited in judicial opinions. As the Supreme Court has explained, "although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."' Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962).
>
> In the case at bar, the court expressly stated that the TAM did not bind [the government]. The court fully evaluated [the government's] argument, but found that the uncontroverted facts did not support [the government's] position. After reviewing the factual

record, the court discussed and quoted the TAM to note that it reinforced plaintiff's independently viable position.

See also *Merchant v. Kelly, Haglund, Garnsey & Kahn*, 874 F. Supp. 300 (D. Colo. 1995), where the court held that the trier of fact in a malpractice lawsuit should consider the attorney's failure to take account of a prior letter ruling adverse to his client's position when planning a transaction.

A recent Federal Claims Court decision, *Amergen Energy Co., LLC ex rel. Exelon Generation Co., LLC v. United States*, 94 Fed. Cl. 413 (2010), also discussed the limited use of private letter rulings, as follows:

> The parties clearly disagree as to the relevance of a private letter ruling, issued by the IRS to one taxpayer, to the litigation of a different tax claim brought by another taxpayer. Plaintiff's argument is founded on assumptions that the court cannot endorse. First, plaintiff states that "[t]he Court of Federal Claims . . . has ruled repeatedly that PLRs can be relevant to ongoing litigation, and many cases have explicitly considered PLRs as evidence." This statement does not give a full picture of this court's, or other courts', consideration of PLRs in tax cases.
>
> [Ed.—The court noted in footnote 6 that plaintiff relies extensively on *IBM v. United States*, 170 Ct. Cl. 357, 343 F.2d 914 (1965), a case with thirty negative citing references, and omits any reference to the precedential limitation of the holding of that case to its facts (citations omitted).]
>
> Private letter rulings, like certain other written determinations issued by the IRS, "may not be used or cited as precedent." 26 U.S.C. § 6110(k)(3) (2006). Most courts, therefore, do not find private letter rulings, issued to other taxpayers, to be of precedential value in deciding the tax claims before them (citations omitted).

[D] Other Agency Guidance

Various documents explain the basis for conclusions reached in various rulings. The detailed legal reasoning behind the issuance of a Revenue Ruling often appears in General Counsel Memorandums (GCMs); but GCMs are not used much anymore. They have been replaced by Chief Counsel Advisories (CCAs). Similarly, an Action on Decision (AOD) explains the decision to acquiesce or nonacquiesce in a Tax Court decision. Lawyers often find material discussed and cited in GCMs, CCAs, and AODs very useful as research tools. GCMs, CCAs, and AODs are available to the public (see **§ 6110(i)**), and are published privately.

In *Nathel v. Commissioner*, 615 F.3d 83 (2d Cir. 2010), the court refused to give *Chevron* guidance to a GCM, as follows:

> I.R.S. General Counsel Memoranda are informal documents written by the I.R.S. Chief Counsel's office. They provide the Chief Counsel's opinion on particular tax matters before other I.R.S. officials. The Memorandum at issue in this case includes a disclaimer that it is "not to be relied upon or otherwise cited as precedent by taxpayers." As a result, the Memorandum is not entitled to deference under Chevron U.S.A. Inc. v. National Resources Defense Council, Inc., 467 U.S. 837 (1984), because it is an informal letter that itself renounces any force-of-law effect. See

United States v. Mead Corp., 533 U.S. 218, 226-27 (2001) (holding that Chevron deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority"); Christensen v. Harris County, 529 U.S. 576, 587-88 (2000) (holding that agency interpretations contained in informal opinion letters are not entitled to Chevron deference). Any "respect" afforded to the Memorandum would only be proportional to its "power to persuade" pursuant to Skidmore v. Swift & Co., 323 U.S. 134, 140. In this case, we decline to rely on the Memorandum because it disclaims precedential effect and is not entitled to deference under Chevron.

§ 6.03 Tax Law Adjudication

[A] Agency Level

Page 124, add the following

Omission from gross income? Is there an omission from gross income in the nonbusiness context when there is an overstatement of cost and, therefore, a six year statute of limitations? For example, if a taxpayer claims a $10,000 cost on the sale of an investment asset for $10,000, but the correct cost is zero, there is a $10,000 understatement of gross income, but is there an "omission" from gross income? A Supreme Court case had interpreted an earlier version of the Code (the 1939 Code) to mean that an overstatement of cost did *not* constitute an omission from gross income (Colony v. Commissioner, 357 U.S. 28 (1958)), and the 1954 Code explicitly adopted that view with regard to business income. The Treasury issued a Regulation stating that, in the *nonbusiness* context, an overstatement of basis was an omission from gross income. **Treas. Reg. § 301.6501(e)-1(a)(iii).** Federal courts usually defer to reasonable regulations when the statute is unclear (under the Chevron case), and even uphold a regulation disagreeing with a prior judicial interpretation as long as the prior judicial interpretation resolved a statutory ambiguity. National Cable & Telecommunications Assn. v. Brand X Internet Services, 545 U.S. 967 (2005). However, in United States v. Home Concrete & Supply, LLC, 132 S.Ct. 1836 (2012), in an opinion by Justice Breyer, the Court followed the Colony case and rejected the Treasury Regulation – an overstatement of basis was not an omission from gross income under **§ 6501(e)(1)(A)** in the nonbusiness context. It reached this conclusion even though the Colony case had acknowledged that the 1939 Code provision was ambiguous and even though the 1954 Code provision favorable to business income arguably left open the treatment of nonbusiness income. Apparently, the fact that the Colony case predated Chevron mean that the concept of "ambiguity" for purposes of applying Brand X is different depending on when the court has interpreted the prior law that the agency wants to override by a regulation. If you have trouble wrapping your mind around this complication, do not be too disturbed. So did Justice Scalia, who refused to join the part of Justice Breyer's opinion dealing with the Brand X case.

[B] Court Level

Page 126, add the following

An intriguing question is whether different courts are disposed to take different approaches to interpreting the income tax code. In *Shores, Textualism and Intentionalism in Tax Litigation*, 61 Tax Lawyer 53 (2007), the author looked at how the Tax Court and the Courts of Appeals dealt with ten cases in which there was a clear difference in result depending on whether the court deferred to

the plain meaning of the text or relied on other evidence of legislative intent. The finding was that the Tax Court relied on intent in every such case, but the Courts of Appeals relied on plain meaning.

Query. If this finding holds up across a wide range of cases, why might it be true? Does the "expert" Tax Court believe it has better insight into the underlying meaning of the Code than generalist courts?

Pages 126-130

Delete § 6.04 and replace with the following

§ 6.04 Ethical Responsibilities of a Representative

It is often said that the law is what the judge says it is, because the court's judgment is the operative event in the application of the law. An even more realistic way to describe what makes law is that the law is what the lawyer (or other representative) says it is, because most issues are not litigated in an administrative or judicial process. It is, therefore, useful in thinking about tax law to consider the tax advisor's ethical responsibilities, based on the American Bar Association interpretations of the Code of Professional Responsibility and the Treasury's rules appearing in Circular 230.

It will help you to focus on this material if you have some substantive issues in mind — for example: (1) If your client won a prize of a car on a quiz show, could you advise him to report a value based on his subjective value for the car? (2) Would your advice be different if your client received a car from his employer?

It will also help if you keep in mind the following questions: (1) Would it be ethical to consider the likelihood of an audit when you give tax advice; (2) To what extent would your advice be shaped by the risk of penalties; (3) When is disclosure of information about a questionable position relevant?

In addition to the ethical rules, there are statutory penalties imposed on taxpayers and tax return preparers and these penalties rely on standards of behavior similar to the ethical standards imposed on tax advisors. The following discussion, therefore, provides some information about these penalties — both because they are important in their own right and because of the light they might shed on the ethical standards. Indeed, the rules dealing with penalties have had an impact on the evolution of the ethical standards

It will help you to manage the detail in these rules if you keep in mind the following possible standards regarding the likelihood of success in a tax dispute:

Reasonable basis of success for the taxpayer
Realistic possibility of success for the taxpayer (the "1/3rd" standard)
Substantial authority for the taxpayer's position
More likely than not to succeed (the "greater than 50% standard)

The discussion begins with the 1967 and 1985 ABA Formal Opinions; then considers statutory penalty provisions which postdate the 1985 ABA Opinion; and then moves on to the subsequently-adopted Treasury rules.

[A] ABA Rules

A 1967 American Bar Association Formal Opinion 314 stated that a ”lawyer who is asked to advise his client in the course of the preparation of the client's tax returns may freely urge the statement of positions most favorable to the client just as long as there is a *reasonable basis* for those positions.” It goes on to insist that the “lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures.”

More recently, in 1985, the American Bar Association reconsidered the reasonable basis test in Formal Opinion 85-352. It adopted a *realistic possibility of success* standard, although it claimed that this was no different from reasonable basis. (This opinion did not deal with a lawyer's opinion on tax shelter investment offerings, which is specifically addressed in ABA Formal Opinion 346 and which is discussed in Chapter 17.06[B].) The 1985 Opinion also states that the “lawyer has no duty to require as a condition of his or her continued representation that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures.” However, the lawyer should explain the potential application of **§ 6662**. That section, discussed below, imposes a penalty when there is a substantial understatement of tax. The **§ 6662** penalty can be avoided if the facts are adequately disclosed and there is a reasonable basis for the taxpayer’s position or if there is substantial authority for the taxpayer’s position. The lawyer is expected to advise the client of the opportunity to avoid this penalty by adequately disclosing the facts in the return or in a statement attached to the return. But, the Opinion repeats, a lawyer is under no obligation to make a disclosure if the client decides to risk the penalty without disclosing the questionable item. The Opinion sums up:

> In summary, a lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no “substantial authority"' in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated. In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

Note that, according to the ABA Opinion, there can be a reasonable possibility of success even though the “substantial authority” test is not satisfied. How can that be? Consider this question later when you read what counts as substantial authority.

[B] Related Penalties

[1] Substantial Understatement Penalty

No one pretends that it is easy to determine when there is a “realistic possibility of success,"' as it was understood in 1985 when the ABA adopted Formal Opinion 85-352. One possible clue is the concept of “substantial authority” as it relates to the 20% “substantial understatement"' penalty in **§ 6662**. For individuals, an understatement is “substantial” if the tax required to be shown on the tax return minus the tax actually shown on the return (that is, the “understatement”) exceeds the greater of 10% of the required tax or $5,000. Consequently, a lower income taxpayer whose

underpayment is more than 10% of the required tax would probably not be subject to the penalty if the underpayment was less than $5,000.

The substantial understatement penalty is imposed when the taxpayer takes a position for which there is no "*substantial authority,*" unless the taxpayer "adequately discloses" the position on the return or attached statement and that position has a *reasonable basis*. **§ 6662(d)**. A "reasonable basis" test is "significantly higher than not frivolous or not patently improper" and is "not satisfied by a return position that is merely arguable." **Treas. Reg. 1.6662-3(b)(3).** The Regulations authorize the government to permit disclosure by filing an accurate return instead of a supplemental form containing the disclosure information. See **Treas. Reg. § 1.6662-4(f)(1-2);** Rev. Proc. 2011-13, 2011-3 I.R.B. 318; Form 8275.

In certain cases, referred to as tax shelters, adequate disclosure is insufficient and the taxpayer must also reasonably believe that his position is "more likely than not" correct, discussed in Chapter 17.06[B].

As noted above, the ABA Opinion assumes that there can be a "realistic possibility of success" without "substantial authority." However, the meaning of "substantial authority" has undergone some dilution since 1985, when the ABA Opinion was issued. The Treasury has complied with a 1989 Committee Report calling for the expansion of the authorities which can provide "substantial authority." Previously, "substantial authority" included cases, temporary and final Regulations, Revenue Rulings, and authoritative committee reports, but now also includes proposed regulations, post-October 31, 1976 letter rulings and taxpayer advice memoranda, post-March 12, 1981 General Counsel Memoranda and Actions on Decisions, Internal Revenue Service Notices, and the Blue Book (which is an explanation of the law written after its passage by the staff of the Joint Committee on Taxation). **Treas. Reg. § 1.6662-4(d)(3)(iii).** This expansion probably reflects the fact that courts place more weight on these aids to interpretation than was previously thought (especially letter rulings and taxpayer advice memorandums). It is unclear whether reliance on this broadened definition of "substantial authority" for penalty purposes will turn out to equate with the "reasonable possibility of success" as an ethical standard.

There is "substantial authority" "only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." **Treas. Reg. § 1.6662-4(d)(3)(i-ii)**. There is little guidance regarding what is meant by "weight," although the Regulations state that a Revenue Ruling is accorded greater weight than a letter ruling. Moreover, older letter rulings, technical advice memorandums, and general counsel memorandums are generally accorded less weight than more recent documents (with such documents that are more than 10 years old "generally . . . accorded very little weight.") The Regulations state that "[c]onclusions reached in treatises [and] legal periodicals . . . are not authority."

Whatever is meant by "realistic possibility of success" and "substantial authority," **§ 6662** assumes that "a reasonable basis" is a more lax standard — because a taxpayer who lacks substantial authority can still avoid the penalty with disclosure, if there is a "reasonable basis." Presumably, some more subtle calculation of the weight of the documents relevant for identifying substantial authority might result in satisfying a reasonable basis test even though there is no "substantial authority." (The same question should be asked about the ABA's "realistic possibility of success" standard.)

One more point about the **§ 6662** penalty. **§ 6664(c)** provides that there will no penalty under **§ 6662** if "it is shown that there was a reasonable cause for [the substantial understatement] and that the taxpayer acted in good faith with respect to [that understatement]." In *Murfam Farms, LLC ex rel. Murphy v. United States*, 94 Fed. Cl. 235 (2010), the court noted that "[r]eliance on . . . the advice of a professional tax advisor . . . does not necessarily demonstrate reasonable cause and good faith." The court continued:

> In the circumstances presented here, reliance on [Ernst & Young's] advice was not reasonable. As the Federal Circuit stated in [another case]: "Reliance is not reasonable, for example, if the adviser has an inherent conflict of interest about which the taxpayer knew or should have known." The Murphys could not reasonably have expected to receive independent advice from the same firm that was selling them [a tax shelter]. Because Ernst & Young had a financial interest in having the Murphys participate in [the tax shelter], the firm had an inherent conflict of interest in advising on the legitimacy of that transaction.
>
> That conflict of interest was exacerbated by the fee structure. The Murphys have conceded that from the beginning they understood that Ernst & Young's fee would be a percentage of their desired tax loss. ("The Murphys believed initially that the fees for [tax shelter transaction] were to be 4.5% of the tax benefits or tax savings from the [] transaction."). In other words, the Murphys understood that the more taxes they avoided by following Ernst & Young's advice the more they would pay [] in fees. The Murphys knew that Ernst & Young stood to earn millions by advising them to participate in [the tax shelter], and they therefore knew or should have known that Ernst & Young's advice lacked the trustworthiness of an impartial opinion. Given Ernst & Young's obvious conflict of interest, reliance on its advice does not demonstrate that Murfam acted with reasonable cause or in good faith.

[2] Return Preparer Penalty

§ 6694(a) imposes a penalty on return preparers. For tax returns prepared after May 25, 2007, the standards for the return preparer penalty have been revised to conform to standards applicable to the substantial understatement penalty. First, for *undisclosed* positions, substantial authority will suffice (reduced from a higher "more likely than not" standard). In addition, there is this additional wrinkle: the penalty if avoided if there is *reasonable* cause for the understatement and the tax return preparer acted in good faith. Second, for *disclosed* positions, a lower reasonable basis standard applies.

The penalty is the greater of $1,000 or 50% of the income derived by the preparer from preparing the return; these figures are increased to $5,000 and 50% if the tax return preparer willfully understates tax liability or acts in reckless manner or with intentional disregard of rules and regulations.

[C] Treasury Rules

The Treasury has issued ethical rules applicable to those who practice before the Treasury. These rules apply not only to lawyers but also to certified public accountants and those who pass a qualifying examination to practice before the IRS. They are published in Circular 230, 31 Code of Federal Regulations, Part 10.

The latest version of Circular 230, sec. 10.34, issued on June 3, 2011, conforms the ethical standard imposed by the Treasury to the return preparer penalty rules (for the most part). The practitioner "may not willfully, recklessly, or through gross incompetence – (a)(1)(i) Sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that -- (A) Lacks a reasonable basis; [or] (B) Is an unreasonable position as described in § 6694(a)(2) of the Internal Revenue Code (Code) (including the related regulations and other published guidance) . . . ." (The same standard applies to advising the client to take a position on the tax return.) The substantial authority standard for undisclosed positions results from the reference to "an unreasonable position as described in § 6694(a)(2)."

There are, however, two important differences between the Treasury's ethical rules and the preparer penalty. First, there is no reasonable cause/good faith exception under the ethical rules, as there is for avoiding the preparer penalty. Second, the Treasury's ethical rules apply only to "willful or reckless behavior or gross incompetence." The rules state that a "pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross negligence." Will the "pattern of conduct" criterion ease a practitioner's concern about application of the ethical rules.

Current law attempts to put more teeth into enforcement of Circular 230 by adding censure and monetary penalties to the existing disbarment and suspension sanctions available to the Treasury. **31 U.S.C. § 330(b)**. Presumably, these lesser sanctions are more likely to be used than disbarment or suspension.

There are two interesting difference between the Treasury and the ABA ethical standards. First, the ABA rejects any rule that favors disclosure by the practitioner. Under the ABA rules, the attorney only has to advise the client on the importance of disclosure to avoid understatement penalties. Under the Treasury rules, disclosure reduces the standard from substantial authority to reasonable basis. Second, the ABA requires only a realistic possibility of success (the one-third standard), but the Treasury requires substantial authority for undisclosed positions.

Chapter 7

INCOME IN-KIND

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§ 7.02 Employee Fringe Benefits

[C] The Statutory Exclusion Rules

[2] Working Conditions

Page 143, add the following

f. IRS Notice 2011-72 provides as follows regarding employer-provided cell phones:

> Many employers provide their employees with cell phones primarily for noncompensatory business reasons. The value of the business use of an employer-provided cell phone is excludable from an employee's income as a working condition fringe to the extent that, if the employee paid for the use of the cell phone themselves, such payment would be allowable as a deduction under section 162 for the employee.
>
> An employer will be considered to have provided an employee with a cell phone primarily for noncompensatory business purposes if there are substantial reasons relating to the employer's business, other than providing compensation to the employee, for providing the employee with a cell phone. For example, the employer's need to contact the employee at all times for work-related emergencies, the employer's requirement that the employee be available to speak with clients at times when the employee is away from the office, and the employee's need to speak with clients located in other time zones at times outside of the employee's normal work day are possible substantial noncompensatory business reasons. A cell phone provided to promote the morale or good will of an employee, to attract a prospective employee or as a means of furnishing additional compensation to an employee is not provided primarily for noncompensatory business purposes.
>
> This notice provides that, when an employer provides an employee with a cell phone primarily for noncompensatory business reasons, the IRS will treat the employee's use of the cell phone for reasons related to the employer's trade or business as a working condition fringe benefit, the value of which is excludable from the employee's income and, solely for purposes of determining whether the working condition fringe benefit provision in section 132(d) applies, the substantiation requirements that the employee would have to meet in order for a deduction under §162 to be allowable are deemed to be satisfied. In addition, the IRS will treat the value of any personal use of a cell phone provided by the employer primarily for noncompensatory business purposes as excludable from the employee's income as a de minimis fringe benefit. The rules of this notice apply to any use of an employer-

provided cell phone occurring after December 31, 2009. The application of the working condition and de minimis fringe benefit exclusions under this notice apply solely to employer-provided cell phones and should not be interpreted as applying to other fringe benefits.

[3] Parking

Page 143, add the following

The inflation-adjusted amount that can be excluded as a parking fringe benefit is **$240** per month for 2012.

The exclusion of parking fringe benefits is one of several "qualified transportation fringe benefits" eligible for a tax break. The most recent tax break is an exclusion of an employer reimbursement for bicycle expenses, not to exceed $20 per month during which the employee regularly bikes to work. The amount is small but is a triumph of political symbolism. The taxpayer cannot take advantage of the parking fringe benefit exclusion during any month for which the $20 bicycle expense exclusion is used.

[E] Cafeteria Plans

Page 145, add the following

Tax breaks under cafeteria plans (**§ 125**) are available only if the benefits do not discriminate in favor of highly compensated employees or key employees. This requirement discouraged adoption of these plans in some instances, so the Patient Protection and Affordable Health Care Act provides that (beginning in 2011) "small employers" will be deemed to meet nondiscrimination requirements if they adopt "simple cafeteria plans." In general, a small employer is one that employs an average of 100 or fewer employees during either of two preceding years. A "simple cafeteria plan" must meet certain minimum eligibility and participation requirements and the employer must make contributions to providing employees with plan benefits.

One of the benefits that can be provided under a cafeteria plan is a Flexible Spending Arrangement covering medical expenses (a Health FSA), without the limits imposed on eligibility for an HSA. Beginning in 2013, no more than $2,500 (indexed for inflation beginning in 2014) can be contributed tax free to a Health FSA.

Chapter 8

DEDUCTIONS FROM INCOME

§ 8.01 Introduction

[A] Statutory Rules

Page 151, add the following

The above the line deduction for teachers (up to $250 per year) has been extended through 2012.

Page 152, add the following

Business vs. nonbusiness activity. In *Forrest v. Commissioner*, T.C. Memo. 2009-228, 98 T.C.M. (CCH) 316 (2009), the court held that the taxpayer's activities in 2003 in trying to earn money as a contract attorney were not "regular and continuous" and therefore did not amount to a trade or business. The court stated the facts as follows:

> Before 1988 petitioner worked as a contract attorney performing various legal services, e.g., researching legal issues, attending hearings, etc., on behalf of other attorneys. She represented her own clients on occasion, but this was rare. . . . From 1988 until her employment was terminated in 2000 she worked as a securities regulator for the California Department of Corporations (the department). Petitioner worked as a contract attorney again in 2000 but not at all during 2001 and 2002.
>
> In 2003 petitioner decided once again to try to work as a contract attorney. She attended the ABA 2003 Midyear Meeting in Seattle, Washington, on February 8-11. While there she attended a women's caucus luncheon, a solo and small firm lawyers breakfast caucus, and seminars on securities law. Petitioner networked with colleagues and informed them she was available as a contract attorney to perform various legal services on their behalf. Petitioner also purchased various supplies, including a computer, printer, paper products, etc., as well as telephone, fax, and Internet services between January and March 2003. Petitioner attempted to be reinstated as a securities regulator by the department and eventually filed suit against the department in 2003. She used some of the supplies she had purchased to assist in her reinstatement efforts. Before petitioner secured any clients or earned any income as a contract attorney in 2003, she was reinstated by the department and returned to work on or around March 25.

The court rejected the taxpayer's argument that her "activity was a continuation of a trade or business carried on previously; i.e., in the 1980s and in 2000. [E]ven if her activities in the past amounted to a trade or business, which we do not decide, there was a substantial lack of continuity between her prior work and her efforts in 2003. Petitioner did not work as a contract attorney

between 1988 and 2000 while she worked for the department. She also did not work as a contract attorney in 2001 or 2002, and her activity in 2003 was sporadic. Accordingly, under the facts of this case petitioner's activity in 2003 was not a continuation of a trade or business carried on in any previous period."

As for the taxpayer's work as a contract attorney from mid-January of 2003 to around March 25, 2003, when she returned to her job as a securities regulator, this was not a "substantial time period." And, "[e]ven though [taxpayer] expended some time and effort in an attempt to find work as a contract attorney during this period, her involvement was not regular and continuous. Her only activity was her attendance at the ABA meeting for 4 days in February, at which petitioner marketed herself to other attorneys. She did not negotiate for or perform any legal services as a contract attorney for any party during this period. Finally, she abandoned her efforts upon returning to the department in late March. Accordingly, her activity was neither regular nor continuous."

§ 8.03 Dependent Care

[A] Modern Statutory Rules

Page 161, add the following

The increased credit percentages and the higher income limits provided by the 2001 Tax Law have been extended by the 2010 Tax Relief Act through 2012.

§ 8.04 Traveling Expenses

[A] Meals and Lodging

[3] Temporary Worker

Page 168, add the following

In *Wilbert v. Commissioner*, 553 F.3d 544 (7th Cir. 2009), Judge Posner narrowly interprets the deduction for meals and lodging by a "temporary worker." The taxpayer was a laid-off airline mechanic who lived with his wife in Minneapolis. Pursuant to his contract, he had a right to bump a more junior mechanic employed by the airline, which he did by taking temporary jobs in Chicago (a few days), Alaska (three weeks), and New York (one week). At no point during this period did he have a justifiable expectation of being rehired in his Minneapolis job within a short period after the initial layoff. The court stated:

> The Tax Court, with some judicial support, has tried to resolve cases such as this by asking whether the taxpayer's work away from home is "temporary" or "indefinite," and allowing the deduction of traveling expenses only if it is the former. The Internal Revenue Code does not explicitly adopt the distinction, but does provide (with an immaterial exception) that "the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year." 26 U.S.C. § 162(a).

The problem with the Tax Court's distinction is that work can be, and usually is, both temporary and indefinite, as in our lawyer example. A lawsuit he is trying in London might settle on the second day, or last a month; his sojourn away from his office will therefore be both temporary and indefinite. Indeed all work is indefinite and much "permanent" work is really temporary. An academic lawyer might accept a five-year appointment as an assistant professor with every expectation of obtaining tenure at the end of that period at that or another law school; yet one would not describe him as a "temporary" employee even if he left after six months and thus was not barred from claiming temporary status by the one-year rule. . . .

So "temporary versus indefinite" does not work well as a test of deductibility and neither does "personal choice versus reasonable response to the employment situation," tempting as the latter formula is because of its realism. If no reasonable person would relocate to his new place of work because of uncertainty about the duration of the new job, his choice to stay where he is, unlike a choice to commute from a suburb to the city in which one's office is located rather than live in the city, is not an optional personal choice like deciding to stay at a Four Seasons or a Ritz Carlton, but a choice forced by circumstances. Wilbert when first notified that he was being laid off could foresee a series of temporary jobs all across the country and not even limited, as we know, to the lower 48 states, and the costs of moving his home to the location of each temporary job would have been prohibitive. It would have meant moving four times in one year on a mechanic's salary to cities hundreds or (in the case of Anchorage versus Minneapolis, Chicago, or New York) thousands of miles apart.

The problem with a test that focuses on the reasonableness of the taxpayer's decision not to move is that it is bound to prove nebulous in application. For it just asks the taxpayer to give a good reason for not moving his home when he gets a job in a different place, and if he gave a good reason then his traveling expenses would be deductible as the product of a reasonable balancing of personal and business considerations. In the oft-cited case of Hantzis v. Commissioner, 638 F.2d 248 (1st Cir.1981), the question was whether a law student who lived in Boston with her husband during the school year could deduct her traveling expenses when she took a summer job in New York. Given the temporary nature of the job, it made perfectly good sense for her to retain her home in Boston and just camp out, as it were, in New York. What persuaded the court to reject the deduction was that she had no business reason to retain the house in Boston. . . .

If this seems rather a mechanical reading of the statute, it has the support . . . of the even more influential precedent of Commissioner v. Flowers, 326 U.S. 465 (1946), where the Supreme Court said that "the exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors" in the decision to travel. The "business exigencies" rule, though harsh, is supported by compelling considerations of administrability. To apply a test of reasonableness the Internal Revenue Service would first have to decide whether the

> taxpayer should have moved to his new place of work. This might require answering such questions as whether the schools in the area of his new job were far worse than those his children currently attend, whether his elderly parents live near his existing home and require his attention, and whether his children have psychological problems that make it difficult for them to find new friends. . . .
>
> We are sympathetic to Wilbert's plight and recognize the artificiality of supposing that, as the government argues, he made merely a personal choice to "commute" from Minneapolis to Anchorage, and Chicago, and New York, as if Minneapolis were a suburb of those cities. But the statutory language, the precedents, and the considerations of administrability that we have emphasized persuade us to reject the test of reasonableness. The "temporary versus indefinite" test is no better, so we fall back on the rule of Flowers and Hantzis that unless the taxpayer has a business rather than a personal reason to be living in two places he cannot deduct his traveling expenses if he decides not to move. Indeed, Wilbert's situation is really no different from the common case of the construction worker who works at different sites throughout the country, never certain how long each stint will last and reluctant therefore to relocate his home. The construction worker loses, as must Wilbert. E.g., Yeates v. Commissioner, 873 F.2d 1159 (8th Cir.1989).

There are two problems with this decision from the perspective of precedent: The construction worker case cited by Posner involved an indefinite job; and the IRS applies the one-year rule based on the taxpayer's expectations, not the actual period of work. Nonetheless, is Posner correct that a "reasonableness" test is too hard to administer? In this respect, he sets himself against Judge Friendly's position in Rosenspan—that "[w]hen an assignment is truly temporary, it would be unreasonable to expect the taxpayer to move his home, and the expenses are thus compelled by the 'exigencies of business.'"

[5] Introductory Language of § 162

Page 169, add the following

Proposed Regulation sec. 1.162-31 deals with the deduction of expenses for lodging when *not* traveling away from home and the correlative exclusion of employer reimbursement for such expenses. An introductory comment (subsection (a)) states that "one factor is whether the taxpayer incurs the expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer." Subsection (b) provides a safe harbor for local lodging at business meetings and conferences, stating that a deduction or exclusion will be allowed if:

> (1) The lodging is necessary for the individual to participate fully in or be available for a bona fide business meeting, conference, training activity, or other business function;
> (2) The lodging is for a period that does not exceed five calendar days and does not recur more frequently than once per calendar quarter;
> (3) If the individual is an employee, the employee's employer requires the employee to remain at the activity or function overnight; and
> (4) The lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit.

Subsection (c) gives some examples:

> Example 1. (i) Employer conducts training for its employees at a hotel near Employer's main office. The training is directly connected with Employer's trade or business. Some employees attending the training are traveling away from home and some employees are not traveling away from home. Employer requires all employees attending the training to remain at the hotel overnight for the bona fide purpose of facilitating the training. Employer pays the costs of the lodging at the hotel directly to the hotel and does not treat the value as compensation to the employees.
> (ii) Employer has a noncompensatory business purpose for paying the lodging expenses. Employer is not paying the expenses primarily to provide a social or personal benefit to the employees. If the employees who are not traveling away from home had paid for their own lodging, the expenses would have been deductible under section 162(a) as ordinary and necessary business expenses of the employees. Therefore, the value of the lodging is excluded from the employees' income as a working condition fringe under section 132(a) and (d).
>
> Example 3. (i) Employer is a professional sports team. Employer requires its employees (players and coaches) to stay at a local hotel the night before a home game to conduct last minute training and ensure the physical preparedness of the players. Employer pays the lodging expenses directly to the hotel and does not treat the value as compensation to the employees.
> (ii) Employer has a noncompensatory business purpose for paying the lodging expenses. Employer is not paying the lodging expenses primarily to provide a social or personal benefit to the employees. If the employees had paid for their own lodging, the expenses would have been deductible by the employees under section 162(a) as ordinary and necessary business expenses. Therefore, the value of the lodging is excluded from the employees' income as a working condition fringe.

However, the regulation then provides two examples where the employee's lodging is taxable. Example 4 states that an employee who currently lives 500 miles from his new employer's business premises is taxed on employer reimbursements for temporary lodging near the employer's business premises while the employee searches for a residence after being hired by the employer; and Example 5 states that employer-provided lodging is taxable to an employee (who normally commutes two hours each way to her office), when the employee stays at a hotel near the office while working late hours on a project.

Finally, Example 6 provides *non*taxability when the employer "requires an employee to be 'on duty' each night to respond quickly to emergencies that may occur outside of normal working hours. Employees who work daytime hours each serve a 'duty shift' once each month in addition to their normal work schedule. Emergencies that require the duty shift employee to respond occur regularly. Employer has no sleeping facilities on its business premises and pays for a hotel room nearby where the duty shift employee stays until called to respond to an emergency." The "on duty" example is treated more favorably than the "working late" example.

The proposed regulation states that "until these proposed regulations are published as final regulations in the Federal Register, taxpayers may apply the proposed regulations to local lodging

expenses that are paid or incurred in taxable years for which the period of limitation on credit or refund under section 6511 has not expired."

§ 8.08 Estate Planning and Tax Determination Expenses

[B] Burden of Proof

Page 180, add the following

In Jones, *The Burden of Proof 10 Years After the Shift*, 121 Tax Notes 287 (Oct. 20, 2008), the author concludes that the shift in the burden of proof was "dramatically oversold" to the public.

§ 8.09 Business as Pleasure

[A] In General

COMMENTS AND QUESTIONS

Page 181, add the following

4. In *Dennis v. Commissioner*, 100 T.C.M. (CCH) 308 (2010), the court held that the taxpayer's horse breeding activity was "for-profit," in part because his wife's business was not enough to pay their living expenses after accounting for the losses from horse breeding. In addition, the taxpayer's losses were not attributable only to depreciation deductions, but actually impacted the family's cash flow.

Chapter 9

PERSONAL INSURANCE PROTECTION AND PERSONAL LOSSES

§ 9.01 Insurance Protection

[B] Employer-Purchased Insurance

[2] Medical and Disability Insurance

Page 186, add the following

The text notes that there is no nondiscrimination requirement when the employer purchases medical insurance for employees. The Patient Protection and Affordable Health Care Act (Public Law 111-148) modifies that rule in a somewhat odd way. The Act applies nondiscrimination requirements to "group health plans" (other than grandfathered plans in effect on March 23, 2010 and not changed significantly after that date), but the sanction for not meeting this requirement is not the loss of tax exemption. The penalty for providing discriminatory benefits is a complex set of excise taxes on the employer under **§ 4980D**. The law also authorizes a civil action by affected participants and the Department of Labor to compel the provision of nondiscriminatory benefits. Finally, the IRS has stated (in Notice 2011-1) that compliance with the Act is not required until after the agency issues administrative guidance.

§ 9.02 Personal Losses

[B] Uncompensated Losses

[1] Medical Expenses

Page 188, add the following

The Patient Protection and Affordable Health Care Act (Public Law 111-148) increases the 7.5% figure to 10% in 2013, unless the taxpayer or the taxpayer's spouse is at least 65 years of age. For the elderly, the figure remains at 7.5% from 2013-2016.

Page 190, add the following

7. *Cosmetic surgery*. A 10% excise tax is imposed on "indoor tanning services." This tax is all that was left of a proposal to tax cosmetic surgery.

Page 191, add the following

2a. *Sex change. O'Donnabhain v. Commissioner*, 134 T.C. 34 (2010), held that the cost of sex-change surgery and related feminizing hormones were, on the facts, deductible medical expenses. Regulations under **§ 213** included mental illness as a disease for which the taxpayer could incur

deductible medical expenses; and the taxpayer had what the Diagnostic and Statistical Manual of Mental Disorders labeled a "genetic identity disorder (GID)." The court rejected the government's argument that GID was a "social construction" and "not a significant psychiatric disorder." The exclusion from deductible medical care for cosmetic surgery did not apply to the taxpayer because the taxpayer's expenditures were to "treat illness or disease," as provided by **§ 213(d)(9)(B)**.

[2] Medical Savings Accounts and Health Savings Accounts

Page 192, add the following

Beginning in 2011, over-the-counter medications paid for by MSAs and HSAs will be tax free only if they are covered by prescription.

Beginning in 2011, the penalty tax on distributions from an MSA or HSA that are not used for tax free medical expenses has been increased to 20%.

Page 193, add the following

Tax free payment of medical expenses under **§ 105(b)** is available not only for an employee but also for an employee's spouse and dependents. The Health Care and Reconciliation Act of 2010 states that a child under the age of 27 will be *deemed* to be a dependent for purposes of the exclusion from income of employer-funded medical expenses under **§ 105(b)**. It is no longer necessary for this child to be a dependent, which means that the child can provide more than one-half of his or her support and earn more than the exemption amount.

§ 9.03 Tort Recoveries

[A] Physical and Nonphysical Injury

[2] Emotional Distress?

Page 196, add the following

In *Sanford v. Commissioner*, 95 T.C.M. (CCH) 1618 (2008), affirmed, 105 A.F.T.R.2d 2010-1130 (6th Cir. 2010), the taxpayer recovered damages arising from unlawful employment discrimination (sexual harassment). The court concluded that the damages were taxable, stating that it was "evident from the [agency] decision that none of the award was predicated on personal physical injury or physical sickness as the statute requires." Although "the emotional distress manifested itself in physical symptoms such as asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression[, t]hese physical symptoms were not the basis of the award petitioner received. [Taxpayer] sought, and was awarded, relief for sexual harassment, discrimination based on sex, and the failure of the [employer] to take appropriate corrective action. . . . Damages received on account of emotional distress, even when resultant physical symptoms occur, are not excludable from income under section 104(a)(2)."

Stadnyk v. Commissioner, 96 T.C.M. (CCH) 475 (2008), involved false imprisonment, but the taxpayer still lost. The taxpayer admitted that "she did not suffer physical harm during the course of her arrest and detention. She was not grabbed, jerked around, or bruised. Rather, [she] argue[d] that physical restraint and detention constitute a physical injury for purposes of section 104(a)(2). [She] contend[s] that a person does not have to be cut or bruised for physical injury to occur under tort law." The court concluded:

> Physical restraint and physical detention are not "physical injuries" for purposes of section 104(a)(2). Being subjected to police arrest procedures may cause physical discomfort. However, being handcuffed or searched is not a physical injury for purposes of section 104(a)(2). Nor is the deprivation of personal freedom a physical injury for purposes of section 104(a)(2). Physical injury is not required for the tort of false imprisonment to occur. Kentucky courts define false imprisonment as "any deprivation of the liberty of one person by another or detention for however short a time without such person's consent and against his will, whether done by actual violence, threats or otherwise." The tort of false imprisonment protects personal interest in freedom from physical restraint; such an interest is "in a sense a mental one". . . . The alleged false imprisonment against petitioner wife did not cause her to suffer physical injury as required for relief under section 104(a)(2).

In its affirmance (367 Fed. Appx. 586 (6th Cir. 2010) (not selected for publication)), the Court of Appeals stated that "the mere fact that false imprisonment involves a physical act—restraining the victim's freedom—does not mean that the victim is *necessarily* physically injured *as a result of* that physical act.

In *Domeny v. Commissioner*, 99 T.C.M. (CCH) 1047 (2010), the taxpayer suffered a flare up of her multiple sclerosis symptoms as a result of a hostile work environment—for which she received a damage settlement from her employer. The court excluded the damages, stating that they were for an exacerbation of an existing illness. The court did not refer to the legislative history stating that physical manifestations of emotional distress, such as insomnia, headaches, and stomach orders, are not to be treated as physical injuries. Is the court saying that compensation for aggravation of an existing physical sickness is exempt under **§ 104(a)(2)**?

Chapter 10

CHARITY

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§ 10.01 Charitable Deductions

[C] Mechanics

Page 207, add the following

Religious donee. A recent amendment has made it more difficult to sustain a deduction for small contributions to religious institutions. **Section 170(f)(17**) states:

> Recordkeeping.—No deduction shall be allowed under subsection (a) for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

§ 10.02 Tax-Exempt Organizations

[A] In General

Page 209, add the following

The **§ 501(c)(3)** tax exemption for hospitals is now subject to additional requirements (**§ 501(c)**). The hospital must engage in a community health needs assessment every three years and adopt an implementation strategy to meet those needs; adopt and publicize a financial assistance policy and provide emergency medical treatment regardless of eligibility under the financial assistance policy; and withhold certain bill collection activities until it provides the patient with information about the financial assistance policy and determines the patient's eligibility under that policy.

§ 10.03 Defining "Gifts"

[B] Donor Control Over Gift; Donor Relation to Donee

Page 220, add the following

4. In *Free Fertility Foundation v. Commissioner*, 135 T.C. 21 (2010), the taxpayer organized a non-profit corporation to provide the taxpayer's sperm free-of-charge to those women who requested this service. The court denied tax exemption for the corporation, stating:

> [t]he free provision of sperm may, under appropriate circumstances, be a charitable activity. Petitioner, however, does not qualify for tax exemption because the class of

petitioner's beneficiaries is not sufficiently large to benefit the community as a whole. Petitioner contends that "the class of individuals that could be direct beneficiaries of petitioner is extremely large: all women of child-bearing age." To the contrary, the class of potential beneficiaries includes only the limited number of women who are interested in having one man—"Naylor"—be the biological father of their children and who survive the very subjective, and possibly arbitrary, selection process controlled by the Naylors. Over a 2-year period, petitioner received 819 inquiries and provided sperm to 24 women. In deciding who receives the sperm, petitioner has certain preferences that narrow the class of eligible recipients. It is not apparent what, if any, relationship some of these preferences have to the promotion of health. For example, petitioner prefers women "from families whose members have a track record of contributing to their communities" and women "with better education."

[C] The Religious Quid Pro Quo

[2] Religious School Tuition

Page 224, add the following

The Ninth Circuit has affirmed the Tax Court's decision in *Sklar v. Commissioner*, 549 F.3d 1252 (9th Cir. 2008), based on the following reasoning. First, nothing in the exception to the substantiation requirements in **§ 170(f)(8)** expands the definition of a charitable contribution. Second, no part of the tuition payment was deductible under the "dual payment" analysis of American Bar Endowment, 477 U.S. 105 (1986), because the taxpayers did not prove that the payments exceeded the value of a secular education or that they intended to make a gift. Third, the government's concession for payments to the Church of Scientology applied to facts that were different from the religious school tuition in Sklar because religious school education differed from the auditing and training provided by the Church of Scientology and because the tuition purchased secular as well as religious education.

§ 10.04 Noncash Gifts

[A] Appreciated Property

Page 225, add the following

The favorable charitable deduction rules provided by **§ 170(e)(3,6)**—applicable to contributions of pharmaceuticals, food, books, and computers—has been extended through 2011 (not through 2012).

§ 11.03 Other Investment Incentives

[A] Expensing and Short-Period Depreciation

Page 244, add the following

Fast depreciation (including expensing) is a congressional favorite for providing incentives to various types of businesses and activities—often with expiration dates. Some fast depreciation benefits are focused on energy efficiency, such as: costs of facilities producing certain biofuels (through 2012); costs associated with energy efficient commercial buildings (through 2013); qualified "smart" electric meters (no expiration date). In addition, the provision for 15-year MACRS depreciation for certain leasehold improvements and for improvements to restaurant buildings has been extended through 2011.

The 2010 Tax Relief Act extends and expands first-year depreciation for various business investments. Some property is eligible for 100% first-year depreciation through 2011 (that is, expensing) and other property is eligible for 50% first-year depreciation in 2012. **§ 168(k)**.

[2] Section 179

Page 244-45, delete the second paragraph of the section and replace with the following

For 2010 and 2011, the ceiling on the amount that can be expensed under **§ 179** is $500,000 and the threshold above which the amount that can be expensed begins to disappear is $2,000,000 (as provided by the Small Business Jobs Act of 2010, Pub. L. 111-240).

Absent any further change in the law, the amount that can be expensed under **§ 179** in 2012, after adjustment for inflation, is $139,000 and the threshold above which the amount that can be expensed begins to disappear is $560,000—dropping to $25,000 and $200,000 respectively after 2012. We might wonder why the otherwise-generous provisions of the 2010 Tax Relief Act did not extend the higher dollar levels for 2012 and beyond. Perhaps there was a desire not to increase budget deficit projections based on this tax break, especially when it is expected that (in any event) the political climate will end up extending the benefits.

[B] Tax Credits

Page 245, delete the paragraph "Other business credits" and replace with the following

Other business credits. The tax credit mechanism (as well as accelerated depreciation) remains popular for specific investments—on either a temporary or permanent basis. For example, there is now a credit for housing rehabilitation (**§§ 38(b)(1), 46(1), 47**) and investment in low income

housing (**§ 42(a)**). The orphan drug credit was extended by the 1996 Act and made permanent by the 1997 Act (**§ 45C**). The research credit (**§ 41**) has been extended through 2011 (not 2012) by the 2010 Tax Relief Act. And the Work Opportunity Credit provided by **§ 51** has been extended to apply to persons who begin work after August 31, 2011 and before January 1, 2012. A particular favorite is credits for energy efficiency—such as for the purchase of homes and appliances (**§§ 45L, 45M**), extended through 2011.

Page 245, add the following to the discussion of the adoption credit and employer-provided child care

Adoption. The Patient Protection and Affordable Health Care Act (Public Law 111-148) made some changes to the adoption credit. The 2011 ceiling on adoption expenses eligible for a credit is **$13,360** and the credit begins to phase-out when AGI exceeds **$185,210**. In addition, the adoption credit is refundable. The Code section providing the credit is **§ 36C**.

However, the 2010 Tax Relief Act did not extend these benefits through 2012. For 2012, the figures revert to earlier levels (**$12,650** of adoption expenses eligible for the credit, adjusted for post-2010 inflation); and the phase-out threshold will be **$189,710**). The relevant code section will be **§ 23**.

Employer-provided child care. The employer-provided child care credit **(§ 45F**) has been extended through 2012 by the 2010 Tax Relief Act.

§ 11.04 Limitations on Tax Breaks for Investment

[A] Listed Property

Page 245, add the following

Beginning in 2010, cell phones are no longer "listed property," thereby eliminating heightened substantiation requirements. IRS Notice 2011-72.

Chapter 12

LOSSES

§ 12.02 Personal Assets

[B] Deducting Personal Consumption from Use of Personal Assets?

Page 252, add the following

Another context in which recovery of basis upon disposition of an asset might result in the deduction of personal consumption—besides sale of a home—is the sale of life insurance during the insured's life. For example, assume that the taxpayer has paid $500 per year for 10 years to purchase whole life insurance—that is, life insurance that has a savings feature that allows the taxpayer to cash in the policy before death. After 10 years, the contract is sold for $6,000. The question is whether the gain is only $1,000, because the taxpayer can deduct the $5,000 costs in computing gross income.

Deduction of $5,000 would result in deducting some personal consumption because the $500 per year premiums consisted of two parts (a term insurance amount that would not have been deductible if the taxpayer had purchased term life insurance and a saving element that earned interest over the life of the policy). Assume that the total of the premiums attributable to term insurance was $1,500. From an economic perspective, the $3,500 of savings would have earned $2,500 of interest, resulting in a $6,000 cash value after 10 years. The correct computation of gross income would result from allowing the taxpayer to deduct only $3,500 of cost (not the $5,000 that he paid) from the $6,000 payment received from the insurance company.

In Rev. Rul. 2009-13, 2009-1 C.B. 1029, the government ruled that the taxpayer must reduce the cost basis of the sale by an amount equal to the term insurance premium attributable to each yearly premium—in other words, the theoretically correct result. Because this result departed from what many taxpayers had previously thought was the law, the part of the ruling dealing with the sale of the insurance policy was made prospective.

Another part of the ruling dealt with the surrender of the life insurance contract to the insurance company. The ruling posits premiums of $64,000 and a cash value and a $78,000 cash surrender value, which reflected the subtraction of $10,000 of "cost-of-insurance" charges collected by the insurance company for periods ending on or before the surrender of the contract. Because the cash value already reflected a reduction for the insurance portion of the premiums, the basis of the contract remained $64,000, resulting in a $14,000 taxable gain.

Finally, the ruling dealt with the sale of term insurance—hypothesizing a level premium fifteen-year term life insurance contract without cash surrender value in which the monthly premium was $500. Through June 15 of Year 8, the taxpayer paid premiums totaling $45,000 and, on June 15 of Year 8, taxpayer sold the life insurance contract for $20,000. The cost basis was $250, which was the amount of the premium attributable to the second half of June; that is, the period

after the sale for which the taxpayer received no insurance protection. This portion of the ruling was also prospective.

Page 256, add the following

§ 12.05 "Madoff" Losses

Taxpayers who thought they were making investments managed by Madoff's Ponzi scheme found themselves out–of-pocket to the tune of $50 billion (or so). Rev. Rul. 2009-9, 2009-1 C.B. 735, takes some of the sting out of these losses by providing taxpayers with ordinary deductions in the year the loss was discovered (2008), based on the following analysis. The first issue is whether these losses are ordinary or capital. In a section not yet discussed in the course, the Code requires worthlessness of stock to be a capital loss. **§ 165(g)**. The idea is that sale produces a capital loss and there should be no difference between a sale at a loss and the loss of a worthless security. But Madoff never invested the taxpayer's money. Therefore, the loss was a theft loss that results in an ordinary loss, not a loss from a worthless security.

The second issue is whether any of the limitations on deductions apply—the **§ 67** (2%) rules; the **§ 68** (overall limitation on itemized deduction) rules; and the excess-of-10% rule applicable to **§ 165(c)(3)** personal casualty losses. Once again, the taxpayer is in luck. The taxpayer who opened a Madoff account entered into a transaction for profit, so any theft loss was deductible under **§ 165(c)(2)**, not **§ 165(c)(3)**. Investment losses deducted under **§ 165(c)(2)** are not subject to any of these limitations—**§ 67(b)(3)**, **§ 68(c)(3)**, **§ 165(c)(3), (h)(2)(A), (4)(b)**.

What is the amount of the loss deduction in 2008? It obviously includes the amount invested. But it also includes the investment income that was reported as taxpayer income and was purportedly (but not actually) reinvested by Madoff; this is consistent with the idea that basis equals the amount included in gross income. Another "amount of loss" issue is whether the possibility of recovery postpones the loss deduction until such time as any claims are resolved. Rev. Proc. 2009-20, 2009-2 C.B. 112, states that a taxpayer who is not seeking recovery of any of the theft loss from a third party can deduct 95% of the total theft loss; and a taxpayer who is seeking such recovery can deduct 75% of the total theft loss. Adjustments are required in later years (either additional deductions if the loss is total; or an income item if a recovery is for any amount previously deducted).

Finally, it gets even better. We earlier discussed the carryover of net operating loss (NOL) deductions for business losses (Chapter 5, § 5.02). It turns out that the Code treats **§ 165(c)(2)** losses (which include theft losses related to an investment entered into for profit) as attributable to a trade or business for the NOL carryover rules; **§ 172(d)(4)(C)**. Consequently, the Madoff losses can be carried back and forward in the same manner as a business NOL. For 2008, these rules are especially advantageous—permitting a carryback for as many as five years.

Chapter 13

CAPITAL EXPENDITURE VS. CURRENT EXPENSE

Delete § 13.02[B]-13.03 and replace with the following

Pages 259-285

§ 13.02 Acquisition Costs

[B] Tangible Property -- Acquisition and Production Costs

[1] Supreme Court

The Court discussed the capitalization of building costs in the following case.

COMMISSIONER v. IDAHO POWER CO.
418 U.S. 1 (1974)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

[Editor — The taxpayer is a utility. It used cars and trucks to construct assets used to transmit electricity. Cars and trucks are depreciable assets and the taxpayer took depreciation deductions on those assets attributable to the period during which the construction occurred. The Court disallowed the deductions, as follows.]

Our primary concern is with the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities. Over a period of time a capital asset is consumed and, correspondingly over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted. As the process of consumption continues, and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. … When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired.

Construction-related depreciation is not unlike expenditures for wages for construction workers. The significant fact is that the exhaustion of construction equipment does not represent the final disposition of the taxpayer's investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. Construction-related depreciation on the equipment is not an expense to the taxpayer of its day-to-day business. It is, however, appropriately recognized as a part of the taxpayer's cost or investment in the capital asset. The taxpayer's own accounting procedure reflects this treatment, for on its books the construction-related depreciation was capitalized by a credit to the equipment account and a debit to the capital facility account. By the same token, this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost; of course, must be capitalized by the taxpayer having the construction work performed. …

The presence of § 263(a)(1) in the Code is of significance. Its literal language denies a deduction for '(a)ny amount paid out' for construction or permanent improvement of facilities. The taxpayer contends, and the Court of Appeals held, that depreciation of construction equipment represents merely a decrease in value and is not an amount 'paid out,' within the meaning of § 263(a)(1). We disagree.

The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing. The regulations state that the capital expenditures to which § 263(a) extends include the 'cost of acquisition, construction, or erection of buildings.' Treas. Reg. § 1.263(a)-2(a). This manifests an administrative understanding that for purposes of § 263(a)(1), 'amount paid out' equates with 'cost incurred.' The Internal Revenue Service for some time has taken the position that construction-related depreciation is to be capitalized. Rev. Rul. 59-380, 1959-2 C.B. 87; Rev. Rul. 55-252, 1955-1 C.B. 319.

> There is no question that the cost of the transportation equipment was 'paid out' in the same manner as the cost of supplies, materials, and other equipment, and the wages of construction workers. The taxpayer does not question the capitalization of these other items as elements of the cost of acquiring a capital asset. We see no reason to treat construction-related depreciation differently. In acquiring the transportation equipment, taxpayer `paid out' the equipment's purchase price; depreciation is simply the means of allocating the payment over the various accounting periods affected. As the Tax Court stated in Brooks v. Commissioner, 50 T.C., at 935, "depreciation — inasmuch as it represents a using up of capital — is as much an 'expenditure' as the using up of labor or other items of direct cost."

Note on Statutory Interpretation — Consistent Usage. The Court notes that depreciation is *not* a "payment" for purposes of the **§ 170** charitable deduction, but concludes that the charitable deduction rules are irrelevant for identifying when an amount "paid out" must be capitalized under **§ 263**.

A familiar linguistic canon of interpretation presumes that words are used consistently throughout a statute. But modern statutes are often amended at different times and these amendments often have different policy implications, even if the statutory texts are similar. Consequently, it is not unusual to find that the different temporal or policy context in which statutory drafting occurs results in similar terms having different meanings, despite being codified in the same law.

Equating Builder and Purchaser. *Idaho Power* talks about putting the taxpayer who builds its own building on a par with the person who buys the building from a contractor who constructs the building. The decision means that even wages, which are usually deductible business expenses, would be capital expenditures if incurred in connection with an asset's construction. *Idaho Power* accomplishes this result because the depreciation on the equipment used to construct the building (and wages paid to construction workers) would be included in the contractor's costs and therefore in the sale price charged to the taxpayer. However, *Idaho Power* is powerless to completely equate the taxpayer who buys the building from a contractor with a taxpayer who constructs the building. If the taxpayer buys the building for $100,000, it will pay $100,000 out of after tax income, which equals basis. If it builds the building for $90,000, including depreciation in the $90,000 cost, it has a basis of only $90,000. The taxpayer does not include the additional $10,000 of builder profit in income or basis, thereby deferring tax on the $10,000 until the lower depreciation ($90,000 instead of $100,000) results in higher income in later years.

[2] Regulations

Treasury Regulations flesh out the principles underlying the otherwise cryptic statutory language in **§ 263**, which had been applied in *Idaho* Power. The latest version is **Treas. Reg. § 1.263(a)-2T**. Among other things, these regulations require capitalization of payments to facilitate the acquisition or production of tangible property (real or personal). This includes amounts paid to investigate an acquisition. However, there is an exception for the cost of investigating whether and which real estate to acquire; these costs can be expensed. **§ 263** does not require these payments to be capitalized.

"Inherently facilitative" costs must always be capitalized (even for real estate); these include the costs of appraisal, title evaluation, obtaining regulatory approval and licensing, and brokers' commissions. **Treas. Reg. § 1.263(a)-2T(f).** This rule applies even if the property is not acquired. Recovery of costs when the property is not acquired will usually be through a loss deduction (when the effort to acquire the property is abandoned); **§ 165**.

Amounts spent for employee compensation and overhead (that is, expenses internal to the business) are not considered facilitation costs. This means that these expenditures can be expensed but payments to a third party provider must be capitalized.

[3] Defending title

Treas. Reg. § 1.263(a)-2T(e) explicitly states that amounts paid to defend or perfect title must be capitalized. However, Example 2 of these regulations distinguishes a title defense from the following deductible expense – payments incurred to invalidate an ordinance that is adopted several years after the business was established and that would prohibit operation of the taxpayer's business.

[4] De Minimis Expenditures — Is Capitalizing Costs Worth the Trouble?

Sometimes it is not worth the administrative effort to argue about whether small expenditures should be deducted or added to basis. The Temporary Regulations now provide that some small expenditures (but not for land or inventory) do not have to be added to cost. **Treas. Reg. § 1.162-2T(g).** To be eligible, the taxpayer must have expensed the item on a financial statement; and the total of such expenses must be less than or equal to .1 percent of gross receipts for the taxable year or 2 percent of total depreciation for the tax year. Amounts below this threshold can be expensed even if total expenses exceed the threshold. Moreover, this benefit is elective with the taxpayer on an item by item basis. This means that a taxpayer with excessive de minimis expenses should elect to expense those costs with longer depreciation lives that are under the threshold and depreciate the shorter-lived assets over the threshold.

Disposition of property to which the de minimis rule is applied is not a disposition of a capital asset; the gain is ordinary income. This rule (found in the Regulations) is an application of a similar case law recapture rule adopted by the Supreme Court in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983). The usual statutory recapture rules under **§ 1245** would not apply because the cost of the property had not been depreciated.

Even in the absence of a financial statement, a taxpayer can still deduct some de minimis expenditures under **Treas. Reg. § 1.162-3T** (materials and supplies that cost $100 or less).

[5] Uniform Capitalization Rules

Even if an expenditure can be expensed under the rules discussed so far, the taxpayer must still worry about **§ 263A**. When **§ 263A** applies, it requires the capitalization of payments that would otherwise be deductible.

Here is the problem addressed by **§ 263A**. Cases like *Idaho Power* deal with "direct" costs, which can be readily attributed to the production of a specific asset. There are, however, serious accounting problems with allocating "indirect" costs to the construction and production of property for use or sale, and to property purchased for resale. For example, should the salary paid to a manager or a business executive be allocated among various assets constructed, produced, or purchased by the taxpayer? How should interest on corporate loans used to finance construction, production, or purchase of various assets be allocated? Taxpayers were, for a long time, successfully expensing many of these indirect costs and even some direct costs. One example is the permission given to cash basis farmers to expense the direct cost of feeding cattle. **Treas. Reg. § 162-12(a)**.

The statute has now been explicitly amended to require both direct and indirect costs to be allocated to the basis of real or tangible personal property produced by the taxpayer and real or personal property acquired for resale. **§ 263A** (uniform capitalization rules). ("Tangible personal property" includes a film, video tape, book or similar property.) For example, in *PMT, Inc. v. Commissioner*, 72 T.C.M. (CCH) 5 (1996), 75% of the salary of the corporation's president was capitalized as a **§ 263A** inventory cost, because he was intimately involved in production design and development of the corporation's inventory.

There are, however, some explicit statutory exceptions: for example, **§ 263A** does *not* apply to intangible property produced by the taxpayer; or to purchasers for resale with no more than $10 million gross receipts. **§ 263A(b)**.

Another important exception is for farmers under limited circumstances. **§ 263A(d)**. This means that some cash basis farmers who qualify under **§ 263A(d)** can still expense some direct costs, if they are permitted to use the cash method of accounting (**§ 447**) (discussed in Chapter 23.02).

Of special interest to creative authors and artists is **§ 263A(h)**, which exempts such individuals from the **§ 263A** capitalization requirements. Thus, periodically purchased writing materials and artists supplies do not have to be added to the cost of the created product — at least as far as **§ 263A** is concerned. The basic accounting rules distinguishing current expenses from capital expenditures would still apply. *See generally* Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982) (discussing book publisher and author deductions).

Finally, **§ 263A** does not apply to a business engaged in providing services; it only applies to "property." **§ 263A(a)(1), (b)**.

Extensive regulations found in **Treas. Reg. § 1.263A-1 through -15** provide detailed guidance regarding the uniform capitalization rules.

[C] Intangible Property -- Acquisition and Production Costs

[1] The *Indopco* Case

A separate set of regulations deals with expenditures related to intangible assets. These rules were adopted after the following Supreme Court decision.

INDOPCO, INC. v. COMMISSIONER
United States Supreme Court
503 U.S. 79 (1992)

JUSTICE BLACKMUN delivered the opinion of the Court.

[Editor — A corporation was a target of a friendly takeover. The taxpayer, Indopco, Inc. (formerly named National Starch and Chemical Corporation) manufactures and sells adhesives, starches, and specialty chemical products. Representatives of Unilever United States, Inc., expressed interest in acquiring National Starch, which was one of its suppliers, through a friendly transaction. National Starch was a large publicly held corporation with over 6,563,000 common shares held by approximately 3700 shareholders. Frank and Anna Greenwall were the corporation's largest shareholders and owned approximately 14.5% of the common stock. The Greenwalls indicated that they would transfer their shares to Unilever only if a tax-free transaction could be arranged, which was done. National Starch's directors were told by Debevoise, Plimpton, Lyons & Gates, National Starch's counsel, that under Delaware law they had a fiduciary duty to ensure that the proposed transaction would be fair to the shareholders. National Starch thereupon engaged the investment banking firm of Morgan Stanley & Co., Inc., to evaluate its shares, to render a fairness opinion, and generally to assist in the event of the emergence of a hostile tender offer.

The tax issue was whether payments to Debevoise and Morgan Stanley related to the takeover, amounting to about $2,500,000, were capital expenditures. The Court dealt explicitly with its earlier decision in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1981).]

National Starch contends that the decision in Lincoln Savings … announced an exclusive test for identifying capital expenditures, a test in which "creation or enhancement of an asset" is a prerequisite to capitalization, and deductibility under § 162(a) is the rule rather than the exception. We do not agree, for we conclude that National Starch has overread Lincoln Savings.

In Lincoln Savings, we were asked to decide whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary expenses under § 162(a), as Lincoln Savings argued and the Court of Appeals had held, or capital expenditures under § 263, as the Commissioner contended. We found that the "additional" premiums, the purpose of which was to provide FSLIC with a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations, "serv[e] to create or enhance for Lincoln what is essentially a separate and distinct additional asset." "[A]s an inevitable consequence," we concluded, "the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a)."

Lincoln Savings stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance … a separate and distinct" asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. We had no occasion in Lincoln Savings to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, Lincoln Savings holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure. Nor does our statement in Lincoln Savings that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure. Although the mere presence of an incidental future benefit — "some future aspect" — may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. …

In applying the foregoing principles to the specific expenditures at issue in this case, we conclude that National Starch has not demonstrated that the investment banking, legal, and other costs it incurred in connection with Unilever's acquisition of its shares are deductible as ordinary and necessary business expenses under § 162(a).

Although petitioner attempts to dismiss the benefits that accrued to National Starch from the Unilever acquisition as "entirely speculative" or "merely incidental," the Tax Court's and the Court of Appeals' findings that the transaction produced significant benefits to National Starch that extended beyond the tax year in question are amply supported by the record. For example, in commenting on the merger with Unilever, National Starch's 1978 "Progress Report" observed that the company would "benefit greatly from the availability of Unilever's enormous resources, especially in the area of basic technology."…

In addition to these anticipated resource-related benefits, National Starch obtained benefits through its transformation from a publicly held, freestanding corporation into a wholly owned subsidiary of Unilever. …

Courts long have recognized that expenses such as these, "'incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses.'" Deductions for professional expenses thus have been disallowed in a wide variety of cases concerning changes in corporate structure. …

The expenses that National Starch incurred in Unilever's friendly takeover do not qualify for deduction as "ordinary and necessary" business expenses under § 162(a). The fact that the expenditures do not create or enhance a separate and

distinct additional asset is not controlling; the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.

[Editor — These costs do *not* acquire "section 197 intangibles" and therefore cannot be depreciated over 15 years. **§ 197(e)(8)**.]

[2] The Reaction to *Indopco*; The New Regulations

[a] Introduction

The "future benefits" test in the *Indopco* case caused major concerns for taxpayers, because it threatened to require the capitalization of many expenditures for self-created intangibles with the potential to produce future income. Actually, *Indopco* did not exactly adopt a "future benefits" test; it held that the creation of a "separate and distinct" asset was a sufficient but not necessary reason for capitalization and made "future benefits" a factor in requiring capitalization. But that was enough to worry taxpayers.

For several expenditures, the government put the taxpayer at ease:

1. Rev. Rul. 92-80, 1992-2 C.B. 57, stated that "[t]he *Indopco* decision does not affect the treatment of advertising costs under section 162(a) of the Code. These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising."

2. In Rev. Rul. 96-62, 1996-2 C.B. 9, the IRS was similarly permissive of deductions for training costs: "The Indopco decision does not affect the treatment of training costs under § 162. Amounts paid or incurred for training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses under that section even though they may have some future benefit."

3. In Rev. Rul. 94-77, 1994-2 C.B. 19, the IRS also struck a pro-taxpayer note, permitting the deduction of severance pay even though it helped to lower costs and therefore increase future net income. This was an important ruling in light of the move toward downsizing the workforce in the 1990s. The ruling stated: "[A]lthough severance payments made by a taxpayer to its employees in connection with a business down-sizing may produce some future benefits, such as reducing operating costs and increasing operating efficiencies, these payments principally relate to previously rendered services of those employees. Therefore, such severance payments are generally deductible as business expenses… ."

4. In Rev. Rul. 95-32, 1995-1 C.B. 5, the IRS applied the severance payment ruling to a case involving expenditures incurred by a public utility for the implementation and operation of energy conservation programs. The utility paid contractors to install low-cost water heating and lighting systems in its customers' houses and to make energy-saving structural improvements to its customers' houses, without obligating customers to purchase power in the future. The expenditures were not capital expenditures even though they might reduce future operating and capital costs.

However, despite the pro-taxpayer tone of these rulings, the advertising and training cost rulings struck a cautious if limited pro-government note, stating that these costs must be capitalized in unusual circumstances — where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising (citing Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) (capitalization of advertising costs incurred to allay public opposition to the granting of a license to construct a nuclear power plant)); or where training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business (also citing the *Cleveland Electric* case). Moreover, in a later case, the IRS argued that expenditures to *create* an advertising campaign should be capitalized, unlike expenditures to *execute* the campaign (although the court rejected that argument — RJR Nabisco Inc. v. Commissioner, 76 T.C.M. (CCH) 71 (1998)).

In any event, neither taxpayers nor the government seemed content with the uncertainty spawned by the rulings and case law and the result was a new set of Regulations that were generally pro-taxpayer. The Explanation and Summary of Comments to the Regulations state:

> The Regulations] provide that an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure. If the IRS publishes guidance requiring capitalization of an expenditure that produces future benefits for the taxpayer, such guidance will apply prospectively.

This means that taxpayers do not have to worry about the IRS relying on a future benefits test without further notice, except insofar as that test is embodied in the remainder of the new Regulations. One commentator has concluded that, instead of calling these the *Indopco* Regulations, they should be called the anti-*Indopco* Regulations, because they are so pro-taxpayer. Ethan Yale, *The Final INDOPCO Regulations*, 105 TAX NOTES 435, 436 (Oct. 25, 2004) (Special Supplement).

In one respect, the cautious use of the "future benefits" standard in the regulations probably means that one issue which had been contentious prior to the *Indopco* regulations will now be decided for the taxpayer. Two pre-*Indopco* cases had allowed the deduction of costs to investigate business expansion — *Briarcliff Candy Corp. v. Commissioner of Internal Revenue*, 475 F.2d 775, 787 (2d Cir. 1973); *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982) (*en banc*), *reversing*, 651 F.2d 942 (4th Cir. 1981). But, in *Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999), *reversed*, *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), the Tax Court held that *Indopco* had overridden those cases. The regulations do not (in my reading) require that expenditures to produce this future benefit be capitalized, which means that they can be deducted.

[b] *Indopco* Regulations

The structure of the new regulations is as follows: **Treas. Reg. § 1.263(a)-4** sets forth the rules dealing with capitalization of amounts paid to acquire or create intangibles and amounts paid to facilitate the acquisition or creation of intangibles, with the following exception; **Treas. Reg. § 1.263(a)-5** deals with amounts paid to facilitate an acquisition of a trade or business or a change in the capital structure of a business entity. The following discussion touches on selected highlights of these regulations; it makes no attempt to explain every rule or every exception to the rules. The detail should alert you to the fact that deciding whether or not to capitalize costs relating to intangibles is among the most difficult income tax issues.

[i] Amounts Paid to Acquire or Create Intangibles; Treas. Reg. § 1.263(a)-4

Treas. Reg. § 1.263(a)-4 has several important subsections. *First*, **Treas. Reg. § 1.263(a)-4(b)(1)(iii)** repeats the pre-*Indopco* law — that an "amount paid to create or enhance a *separate and distinct* intangible asset within the meaning of paragraph (b)(3)" must be capitalized. This type of asset is defined in paragraph (b)(3) as follows:

> (i) Definition. The term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.

Second, **Treas. Reg. § 1.263(a)-4(c)** deals with the *acquisition* of intangibles, such as the purchase of good will or customer's lists when buying a business. This section often requires the acquisition costs for an intangible to be capitalized, even though expenditures to self-create the intangible might be expensed. This result runs contrary to the policy in the *Idaho Power* case (which involved the capitalization of expenditures to self-create *tangible* assets), where capitalization was justified because it treated acquisition and creation costs in a similar fashion.

Third, **Treas. Reg. § 1.263(a)-4(d)** deals with a variety of expenditures which create intangible value, some of which are noted here. Costs for the following must usually be capitalized: creation of a financial asset (such as a debt instrument or credit card agreement); prepaid expenses (such as prepaid insurance, as in the *Boylston* decision in Chapter 13.02[A]); membership or license fees (such as doctors' payments for hospital privileges, payments to join a trade association, and bar admission fees).

This section of the regulations also requires capitalization of amounts paid to another party to "create, originate, enter into, renew, or renegotiate" certain rights, subject to a de minimis exception; if the payment does not exceed $5,000, it can be expensed. Another exception to this capitalization requirement is an amount paid "with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination,

renewal or renegotiation of an agreement with that party." An example of an expenditure that must be capitalized under this paragraph is a signing bonus to an employee to come to work for the payor, unless the employee can leave the employer without any obligation to repay the bonus.

Termination payments are *not* generally capitalized, but there are three important exceptions. The following must be capitalized: (1) Payments by a lessor to terminate a lease for real or personal tangible property; (2) Payment to terminate an exclusive license or distribution agreement; and (3) Payment to terminate a covenant not to compete. Payments to terminate a transaction involving the potential acquisition of a trade or business are dealt with by **Treas. Reg. § 1.263(a)-5**.

Fourth, **Treas. Reg. § 1.263(a)-4(e)** deals primarily with indirect costs incurred to facilitate the acquisition or creation of intangibles. These costs are generally required to be capitalized if the direct costs must be capitalized, but there are many exceptions. The regulations adopt what it calls simplifying assumptions, which are elective with the taxpayer, and which exclude from capitalized facilitation costs the following: employee compensation (including payments to people who are not employees of the taxpayer if they are for secretarial, clerical, or similar supports services); overhead; and de minimis costs (which do not exceed $5,000). There was some thought given to permitting these simplifying assumptions only if the taxpayer also expensed them for financial accounting, but this proposal did not make it into the final regulations.

[ii] Facilitating Acquisition of Trade or Business or Change in Capital Structure; Treas. Reg. § 1.263(a)-5

A different section of the regulations deals with amounts paid to facilitate transactions to acquire a trade or business or to change the capital structure of a business entity. The general rule is that these amounts must be capitalized, with exceptions.

1. *Termination payments.* An important issue arising in this context is how to deal with termination payments — e.g., when a taxpayer terminates someone's right to acquire its business. **Treas. Reg. § 1.263(a)-5(b)(8)** states:

> An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction … constitutes an amount paid to facilitate a second transaction [and is therefore capitalized] … only if the transactions are mutually exclusive.

"Mutually exclusive" is explained in the following two examples: **Treas. Reg. § 1.263(a)-5(*l*) (examples 13 and 14)**:

> *Example 13. Corporate acquisition; mutually exclusive costs.* (i) [Y, threatened with a hostile takeover by Z] finds W, a white knight. Y and W execute a letter of intent on March 10, 2005. Under the terms of the letter of intent, Y must pay W a $10,000,000 break-up fee if the merger with W does not occur. On April 1, 2005, Z significantly

> increases the amount of its offer, and Y decides to accept Z's offer instead of merging with W. …
> (iii) … [B]ecause Y could not merge with both W and Z, … the $10,000,000 termination payment facilitates the transaction between Y and Z. Accordingly, Y must capitalize the $10,000,000 termination payment as an amount that facilitates the transaction with Z.
> *Example 14. Break-up fee; transactions not mutually exclusive.* N corporation and U corporation enter into an agreement under which U would acquire all the stock or all the assets of N in exchange for U stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party $10,000,000. U decides to terminate the agreement and pays N $10,000,000. Shortly thereafter, U acquires all the stock of V corporation, a competitor of N. U had the financial resources to have acquired both N and V. U's $10,000,000 payment does not facilitate U's acquisition of V. Accordingly, U is not required to capitalize the $10,000,000 payment under this section.

2. *Exploring the acquisition of a business.* The Regulations also deal with payments to investigate the acquisition of a trade or business. **Treas. Reg. § 1.263(a)-5(e)**. They distinguish between pre-investigative payments (which can usually be expensed) and payments to facilitate acquisition of a business (which must be added to cost). Payments are pre-investigative (and can therefore usually be expensed) if they occur before the earlier of two specified events — (1) the date on which a letter of intent is executed by both acquirer and target, or (2) the date on which the material terms of the transaction as tentatively agreed to by both parties are authorized by taxpayer's appropriate officials (or, if authorization is not required, the date on which a binding contract is executed).

However, certain expenditures are "inherently facilitative" and must be capitalized regardless of when they occur — for example: for securing an appraisal or fairness opinion regarding an acquisition; obtaining tax advice regarding the structure of the transaction; and getting regulatory approval. This would probably result in capitalizing most of the expenditures in Indopco, which were incurred for tax advice, an appraisal, and a fairness opinion.

Moreover, the expensing of payments to explore the acquisition of a business is subject to an important qualification. The taxpayer must be in a trade or business, not be entering into a business for the first time or exploring the acquisition of a business unrelated to the business in which he is currently engaged. The possibility of deducting these "start-up" expenditures is discussed later.

3. *Hostile mergers.* The following examples in the regulations (**Treas. Reg. § 1.263(a)-5(*l*)**) discuss whether expenditures to defend against a *hostile* takeover bid must be capitalized, when the bid was eventually successful. The detail in the regulations should alert you to the fact that large amounts of money with tax consequences are at stake in corporate takeovers.

> *Example 11. Corporate acquisition; defensive measures.* (i) On January 15, 2005, Y corporation, a publicly traded corporation,

becomes the target of a hostile takeover attempt by Z corporation. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential ``white knight'' acquirer. Y also pays amounts to complete a defensive recapitalization, and pays $50,000 to an investment banker for a fairness opinion regarding the price contained in Z's initial offer. Y's efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2005, Y's board of directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover, Y pays an investment banker $1,000,000 for a second fairness opinion and for services rendered in negotiating with Z.

(ii) The legal fees paid by Y to seek an injunction against the takeover are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Accordingly, these legal fees are not required to be capitalized under this section.

(iii) The investment banking fees paid to search for a white knight acquirer do not facilitate an acquisition of Y by a white knight because none of Y's costs with respect to a white knight were inherently facilitative amounts and because Y did not reach the [critical date] with respect to a white knight. Accordingly, these amounts are not required to be capitalized under this section.

(iv) The amounts paid by Y to investigate and complete the recapitalization must be capitalized … . [Editor — **Treas. Reg. § 1.263(a)-5(a)(4)**.]

(v) The $50,000 paid to the investment bankers for a fairness opinion during Y's defense against the takeover and the $1,000,000 paid to the investment bankers after Y abandons its defense against the takeover are inherently facilitative amounts with respect to the transaction with Z and must be capitalized … .

Example 12. Corporate acquisition; acquisition by white knight. (i) Assume the same facts as in Example 11, except that Y's investment bankers identify three potential white knight acquirers: U corporation, V corporation, and W corporation. Y pays its investment bankers to conduct due diligence on the financial condition of three potential white knight acquirers. On March 15, 2005, Y's board of directors approves a tentative acquisition agreement under which W agrees to acquire all of the stock of Y, and the investment bankers stop due diligence on U and V. On June 15, 2005, W acquires all of the stock of Y.

(ii) … [T]he amounts paid to conduct due diligence on U, V, and W prior to March 15, 2005 (the date of board of directors' approval) are not amounts paid to facilitate the acquisition of the stock of Y and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on W on and after March 15,

2005, facilitate the acquisition of the stock of Y and are required to be capitalized.

[3] Start-Up Costs

[a] In general

If a taxpayer enters business for the first time (or explores going into an unrelated business), the start-up costs would not be deductible because the taxpayer is not yet in business. The best known case is Richmond Television Corp. v. United States, 345 F.2d 901 (1965) (costs of training personnel prior to beginning business; even though taxpayer made a decision to enter into business and spent money in preparation for entering that business, he has not 'engaged in carrying on any trade or business' within section 162(a) until the business has begun to function as a going concern). If a taxpayer loses a case like Richmond Television, it is especially serious because the asset acquired usually has no ascertainable useful life and is therefore not depreciable under **§ 167**. Moreover, the value of a trained workforce is *not* usually a "section 197 intangible" (**§ 197(d)(1)(C)(i)**), eligible for 15-year depreciation, if it is *self-created*. **§ 197(c)(2)**. A great deal therefore turns on defining when the business begins, after which many of these otherwise-capitalized start-up expenses could be deducted.

[b] Elective Amortization — Section 195

Section 195, passed after Richmond Television, permits the taxpayer to elect to deduct "start-up expenditures" beginning in the year in which the active trade or business begins, as follows: (1) expensing the lesser of (a) the start-up expenditures or (b) $10,000 reduced by the excess of those expenditures over $60,000 and (2) the remainder of those expenditures over a 180-month period beginning with the month when the active trade or business begins. Disposition of the business before completion of the amortization period results in a loss deduction under **§ 165** for unrecovered basis. No deduction is allowed for start-up expenditures except as provided by **§ 195**. This provision takes some of the pressure off distinguishing start-up from post-start-up expenses. However, it is still much better to expense than to rely on **§ 195**.

Section 195 defines eligible start-up expenditures as either "investigation costs" or costs incurred in "creating" a business. Rev. Rul. 99-23, 1999-1 C.B. 998 (excerpted below) adopts a narrow definition of "investigation" costs. **§ 195(c)(1)(A)(i)**. After reading this Revenue Ruling, do you think that the training expenses in Richmond Television would be eligible for **§ 195** deductions?

Rev. Rul. 99-23 first quotes from the legislative history, as follows:

> … [E]ligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. … [T]he amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business.

The ruling then asserts "that expenses incurred in the course of a general search for, or an investigation of, a business that relate to the decisions whether to purchase a business and which business to purchase are investigatory costs. However, once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital in nature." The ruling gives the following example.

> In April 1998, corporation U hired an investment banker to evaluate the possibility of acquiring a trade or business unrelated to U's existing business. The investment banker conducted research on several industries and evaluated publicly available financial information relating to several businesses. Eventually, U narrowed its focus to one industry. The investment banker evaluated several businesses within the industry, including corporation V and several of V's competitors. The investment banker then commissioned appraisals of V's assets and an in-depth review of V's books and records in order to determine a fair acquisition price. On November 1, 1998, U entered into an acquisition agreement with V to purchase all the assets of V. U did not prepare and submit a letter of intent, or any other preliminary agreement or written document evidencing an intent to acquire V prior to executing the acquisition agreement.
>
> The ruling concludes:
>
> [In this example], an examination of the nature of the costs incurred indicates that U made its decision to acquire V after the investment banker conducted research on several industries and evaluated publicly available financial information. The costs incurred to conduct industry research and review public financial information are typical of the costs related to a general investigation. Accordingly, the costs incurred to conduct industry research and to evaluate publicly available financial information are investigatory costs eligible for amortization as start-up expenditures under sec. 195. However, the costs relating to the appraisals of V's assets and an in-depth review of V's books and records to establish the purchase price facilitate consummation of the acquisition, and thus, are capital acquisition costs. The costs incurred to evaluate V and V's competitors also may be investigatory costs, but only to the extent they were incurred to assist U in determining whether to acquire a business and which business to acquire. If the evaluation of V and V's competitors occurred after U had made its decision to acquire V (for example, in an effort to establish the purchase price for V), such evaluation costs are capital acquisition costs.

Rev. Rul 99-23 makes the "final decision" to acquire a trade or business the critical date before which an outlay can be eligible for **§ 195**. In *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), the court held that the taxpayer "made its 'final decision' regarding acquisition no later than July 22, 1991. On that date, [taxpayer] and Norwest entered into the Agreement and Plan

of Reorganization [for taxpayer to merge with Norwest]." Consequently, legal fees to consummate the merger after the final decision had been made were not eligible "start-up expenditures."

The above ruling does *not* deal with **§ 195(c)(1(A)(ii)**, which covers "*creating* an active trade or business," rather than *investigating* the creation of a trade or business. Despite the agency's narrow reading of "investigation" costs, pre-business training costs might be amortizable "creation" costs. *See, e.g.*, Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) (suggesting that pre-business training costs are covered by **§ 195)**. *See also* Rev. Rul. 81–150, 1981 C.B. 119 (management fee paid to managing partner during oil rig construction was a "creation" cost covered by **§ 195**).

§ 248. There is one more section relevant to business "creation" expenditures, adopted in 1976 (four years before **§ 195** was adopted in 1980). **§ 248** permits a deduction of the costs "incident to the creation of a corporation" up to $5,000 (reduced by the excess of such costs over $50,000) and permits the remainder of such costs to be amortized over 180 months beginning with the month in which the business begins. A typical **§ 248** expenditure is the fee paid to a lawyer to organize a corporation.

[c] Research and Development

In one situation, the code permits expensing of outlays before business has begun. **Section 174** permits expensing of research and experimental costs "in connection with a trade or business." *Snow v. Commissioner*, 416 U.S. 500 (1974), held that this language was broader than "carrying on a trade or business" and permitted preoperating outlays to be expensed. The Court was undoubtedly influenced by the fact that the provision was meant as an economic incentive and that any other interpretation would have favored existing businesses over businesses which were still getting started.

[4] Job Search Costs

An older ruling deals with a particular kind of outlay that is often for business expansion but could also be for getting started in business — job search costs (e.g., travel costs or an employment agency fee). Rev. Rul. 75-120, 1975-1 C.B. 55, held the following: (a) job search costs to successfully or unsuccessfully obtain new employment in the *same* trade or business are deductible expenses; (b) job search costs to obtain employment in a *new* trade or business are not deductible, whether or not the search is successful. Is this ruling correct, insofar as it prohibits deduction of unsuccessful search costs to obtain a job in a new trade or business?

It makes sense to distinguish expenditures to successfully acquire a job in the *same* trade or business vs. a *new* trade or business, on the ground that the latter involve the kind of expansion costs that should not be deducted. But why should there be no deduction for the unsuccessful costs of a job search for a *new* trade or business? Isn't there a deductible loss when the costs are unsuccessful?

Is a third year law student taxed on reimbursements received from a law firm for interview travel costs? Presumably, the reimbursements are not a working condition fringe benefit under **§ 132(a)(3), (d)**, because the student is not an employee. But are the reimbursements **§ 61** income?

§ 13.03 Tangible Property -- Repair/Maintenance Expenses vs. Costs for Improvements

Is an expenditure related to property a deductible repair (or maintenance) expense or a capital cost of improvement. Two issues arise. First, what is the unit of property with respect to which this decision is made The larger the unit, the more likely the payment will be a deductible repair of the larger unit rather than a capital cost of a separate item. Second, once the unit is identified, what are the criteria for determining whether a payment is for a repair or an improvement. **Treas. Reg. § 1.263(a)-3T** address these issues in the context of tangible property. In general, the costs are capitalized if they better or restore the property or adapt it for a new use. The Regulations provide extensive examples.

[A] What is the Unit?

The general rule adopted by the Regulations is that all components of property that are "functionally interdependent" are considered a single unit of property. A computer and printer are two units of property because they can be used separately. However, the engine of a truck is not a separate property because the truck cannot run without the engine.

There are some exceptions, of which buildings are an important example. Payments to improve the "building structure" or any one of eight building systems (e.g., heating and air-conditioning; elevators) are considered improvement costs that must be capitalized, even though the building itself is the unit of property. However, these costs are added to the cost of the building (and depreciated over the life of the building), not to the cost of the components of the building.

In addition, a taxpayer who treats a component as a separately depreciable asset must treat that component as a unit of property for applying the repair vs. improvement rules, even if those rules would not otherwise treat that component as a separate unit of property. For example, if the taxpayer treats tires as a unit of property separate from the vehicle, the replacement of the tires is not considered a repair of the vehicle. **Treas. Reg. § 1.263(a)-3T(e)(5)(i) and Example 16**.

[B] Criteria for Distinguishing Deductible Repair Expenses from Capital Improvement Costs

Earlier regulations required an expenditure to be capitalized if it added to a property's value, substantially prolonged its useful life, or adapted it to a new use. The new Regulations replace the first two tests. Expenditures must be capitalized if they better the property (a variation of the "add to value" test, which has been rejected because it is administratively too difficult to apply); or if the expenditures restore the property (a variation on the earlier "prolong useful life" test." The "adapt to new use" test is retained.

[1] Betterment

In general, an expenditure betters property if it:

(1) ameliorates a material condition or defect that either existed before taxpayer's acquisition or that arose during the production of the property;

(2) results in the material addition to the property, such as its enlargement or expansion,; or

(3) results in a material increase in capacity, productivity, efficiency, strength, or quality of the property.

The examples under the Regulations address some typical problems. First, if replacement parts are unavailable (typically, for older property), purchase of an improved part does not in and of itself result in improvement of the property. For example, if wooden shingles are no longer available, replacement of storm-damaged shingles with asphalt shingles is not an improvement even though they add to the strength of the property. However, the cost of other better shingles may be a capital cost. **Treas. Reg. § 1.263(a)-3T(h), Examples 14-15**.

Second, when the taxpayer is correcting a defect in the property, such as a leaking underground storage tank, it does not matter whether the taxpayer knew of the defect when it acquired the property. This can seem unfair to the taxpayer, if the cost of the property was inflated because the taxpayer was unaware of the defect. The discovery of the defect will result in a nondeductible decline in the property's value, but the cost of fixing the defect will still be added to basis. The following examples illustrate this rule.

Example 1. Amelioration of pre-existing material condition or defect. In Year 1, X purchases a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X is not aware of the contamination at the time of purchase. In Year 2, X discovers the contamination and incurs costs to remediate the soil. The remediation costs result in a betterment to the land under paragraph (h)(1)(i) of this section because X incurred the costs to ameliorate a material condition or defect that existed prior to X's acquisition of the land.

Example 2. Not amelioration of pre-existing condition or defect. X owns a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. X determines that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X pays an amount to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more efficient or effective than the asbestos insulation. . . . Although the asbestos is determined to be unsafe under certain circumstances, the asbestos is not a preexisting or material defect of the building structure under paragraph (h)(1)(i) of this section. In addition, the removal and replacement of the asbestos does not result in a material addition to the building structure under paragraph (h)(1)(ii) of this section or result in a material increase in capacity, productivity, efficiency, strength, or quality of the building structure or the output of the building structure under paragraph (h)(1)(iii) of this section. Therefore,

the amount paid to remove and replace the asbestos insulation does not result in a betterment to the building structure under paragraph (h) of this section.

Third, the Regulations specify how to make the comparisons to decide whether there has been an improvement. When there has been an event requiring maintenance, the betterment standard is applied by comparing the condition of the property *after* the expenditure with the condition immediately *before* the event. This is true whether or not the "event" is a law or regulation. If maintenance is needed because of normal wear and tear, the comparison is with the property's condition prior to the last time the taxpayer corrected the effects of wear and tear; or, if this is the first time the taxpayer dealt with wear and tear, the comparison is with the property's condition when it was acquired. The following example illustrates this rule.

Example 12. Not a betterment; regulatory requirement. X owns a meat processing plant. X discovers that oil is seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. X is not required to treat the amount paid as a betterment under paragraph (h) of this section because it does not result in a material addition or material increase in capacity, productivity, efficiency, strength or quality of the building structure or its output compared to the condition of the structure prior to the seepage of the oil. The federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant.

[2] Restoration

Here are some examples of expenditures that result in a capitalized cost of restoration: (1) they replace a component of property for which a loss deduction has properly been taken, whether or not the loss was the result of a casualty; (2) they return property to efficient operation after it has deteriorated so it was no longer functional; (3) they rebuild the property to "like-new condition after the end of its depreciable class life; or (4) they replace a part that is a "major component" of property. An "engine" would be a major component of a vehicle or boat. **Treas. Reg. § 1.263(a)-3T(i)**

The "major component" issue is addressed in the following examples:

Example 8: Replacement of major component or substantial structural part; personal property. X is a common carrier that owns a fleet of petroleum hauling trucks. X pays amounts to replace the existing engine, cab, and petroleum tank with a new engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property, and that the trailer (which contains the petroleum tank) is a separate unit of property. The new engine and cab constitute parts or combinations of parts that comprise a major component or substantial structural part of X's tractor. Therefore, the amounts paid for the replacement of those components must be capitalized under paragraph (i)(1)(vi) of this section. The new petroleum tank constitutes a part or

combination of parts that comprise a major component and a substantial structural part of the trailer. Accordingly, the amounts paid for the replacement of the tank also must be capitalized under paragraph (i)(1)(vi) of this section.

Example 12. Replacement of major component or substantial structural part; roof. X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. X pays the contractor to replace the entire roof with a new roof. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section and comprises a major component or substantial structural part of X's building structure under paragraph (i)(4) of this section. Under paragraph (i)(1)(vi) of this section, X must treat the amount paid to replace the roof as a restoration because X paid the amount to replace a major component or substantial structural part of X's building structure. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid to restore the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section. [Editor -- Example 13 provides the same result as Example 12, if a substantial part of the roof is replaced.]

[3] Adapt to new use

This portion of the Regulations is the same as prior regulations. For example, knocking out walls so that three retail sales rooms are converted to one large retail sale room is not an adaptation to a different use. But, amounts paid to convert a manufacturing building to a showroom are capital expenditures. **Treas. Reg. § 1.263(a)-3T(j) (Examples 1 and 2)**.

[4] Routine Maintenance Safe Harbor

The Regulations provide a safe harbor deduction for expenditures that might otherwise be capitalized if they provide "routine maintenance" on property other than buildings. However, the Regulations do not allow use of the safe harbor if the amount is "paid for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component" or the amount is paid "to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use."

Treas. Reg. § 1.263(a)-3T(g) states:

> An amount paid for routine maintenance performed on a unit of property other than a building or a structural component of a building is deemed not to improve that unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. The

> activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life [] of the unit of property. Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement . . . .

The Regulations provide the following example, which will be of great interest to the aviation industry. Prior rulings had left the industry unsure whether different types of periodic maintenance performed on the aircraft would be capitalized. This example gives them assurance that the payments for at least some of this maintenance can be expensed. Notice that the safe harbor applies even though the depreciable class life has expired. Early deductions through accelerated depreciation can combine with deductible expenses that keep the property going after the end of the class life.

Example 1. Routine maintenance on component. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, X is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which X expects to perform on its aircraft engines approximately every 4 years in order to keep its aircraft in its ordinarily efficient operating condition. In Year 1, X purchased a new aircraft, which included four new engines attached to the airframe. [] In Year 5, X performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in X's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available and reasonable replacement part. After the ESVs, the engines are returned to X to be reinstalled on another aircraft or stored for later installation. Assume that the unit of property for X's aircraft is the entire aircraft, including the aircraft engines, and that the class life for X's aircraft is 12 years. . . .

(ii) Because the ESVs involve the recurring activities that X expects to perform as a result of its use of the aircraft to keep the aircraft in ordinarily efficient operating condition, and consist of maintenance activities that X expects to perform more than once during the 12 year class life of the aircraft, X's ESVs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the ESVs are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 2. Routine maintenance after class life. Assume the same facts as in Example 1, except that in year 15, X pays amounts to perform an ESV on one of the original aircraft engines, after the end of the class life of the aircraft. Because this ESV involves the same routine

maintenance activities that were performed on aircraft engines in Example 1, this ESV also is within the routine maintenance safe harbor []. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

[C] Environmental Clean-Up

Section 198 – which expired after 2011 -- allowed taxpayers to expense "any qualified environmental remediation expenditure," even though the expenditure would have otherwise been a capitalized cost. The statute defined "qualified environmental remediation expenditure" as "any expenditure -- (A) which is otherwise chargeable to capital account, and (B) which is paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site." The statute defined each of the relevant terms, which should be consulted by anyone concerned with the intersection of tax law and environmental policy. The legislative history of the section states that it was not meant to create any inference about whether clean-up costs are or are not currently deductible as expenses under current law.

§ 13.04 Education Expenditures

[A] Trade or Business Expenses?

[5] Employer Fringe Benefit

Page 289

The benefit provided by **§ 127** has been extended through 2012.

[B] Scholarships

[1] Services Required as a Condition of Scholarship

Page 290

2. *Certain government scholarships*. This tax break has been extended through 2012 by the 2010 Tax Relief Act.

[C] Education Tax Subsidies

[1] Hope Scholarship and Lifetime Learning Credits; Section 25A

Page 292, add the following

The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) makes several changes to the Hope Scholarship credit for 2009 and 2010 (referred to as the American Opportunity Tax Credit)—extended to 2012 by the 2010 Tax Relief Act. The amount of the credit is 100% of the first $2,000 of qualified tuition and related expenses (which will include course materials) and 25% of the next $2,000. The credit also applies to the first *four* years of post-

secondary education. In addition, 40% of this credit is now refundable. The phase-out threshold is increased so that it will begin at **$80,000** for a single taxpayer and **$160,000** for a married couple (but is not adjusted for inflation).

The lifetime learning credit phase-out thresholds are different and are adjusted for inflation. For 2012, the phase-out threshold is **$52,000** (single) and **$104,000** (married).

[2] Coverdell Education Savings Accounts; Section 530

The tax break provided by this section has been extended through 2012 by the 2010 Tax Relief Act.

[3] Deduction for Qualified Higher Education Expenses; Section 222

Page 294

The section 222 deduction has been extended through 2011.

Chapter 14

PUBLIC POLICY

§ 14.01 Ordinary, Necessary, Reasonable, Lavish

[B] Excessive Compensation—Reasonable Salary

[2] Employees and Owners

[a] Multi-Factor Test

Page 303, add the following

In *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7th Cir., 2009), reversing T.C. Memo, 2004-207, Judge Posner again refused to characterize as unreasonable a large payment to the company's chief executive (who also owned all of the company's voting stock). Most of the executive's $20 million-plus salary was a 5%-of-net-income bonus equal to $17,467,800. Posner objected to the standard in the Regulations, as follows:

> A difficult case—which is this case—is thus that of a corporation that pays a high salary to its CEO who works full time but is also the controlling shareholder. The Treasury regulation defines a "reasonable" salary as the amount that "would ordinarily be paid for like services by like enterprises under like circumstances," § 1.162-7(b)(3), but that is not an operational standard. No two enterprises are alike and no two chief executive officers are alike, and anyway the comparison should be between the total compensation package of the CEOs being compared, and that requires consideration of deferred compensation, including severance packages, the amount of risk in the executives' compensation, and perks.

Posner's opinion objected (among other things) to the Tax Court's "disregard[ing of the] differences in the full compensation packages of the three executives [of other companies] being compared, differences in whatever challenges faced the companies in 1998, and differences in the responsibilities and performance of the three CEOs."

Page 304, add the following

[c] Financial Institutions Selling "Troubled Assets"

When Congress appropriated billions of dollars to purchase "troubled assets" held by financial institutions (the so-called TARP program), it also passed new rules dealing with executive compensation paid by these institutions. The rules have two parts. First, compensation is limited for senior executive officers when the institution sells troubled assets directly to the Treasury. Second, there are limits on the deduction of such compensation if the institution sells these assets through a public auction and total sales exceed $300 million. Among the rules is a $500,000 limit per year on

the deduction of executive compensation, which (unlike the rules in **§ 162(m)**) includes performance-based compensation, such as stock options.

The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) extends the $500,000 deduction limit to all institutions receiving TARP money, not just financial institutions.

[d] Compensation Paid by Health Insurance Providers

The Patient Protection and Affordable Health Care Act (Public Law 111-148) provides that the deduction for compensation paid by health insurance providers is limited to $500,000. The law applies to payments beginning in 2013 for services performed after 2009. The ceiling on the deduction applies to payment to employees and independent contractors and is not limited to top executives; and there is no exception for performance-based compensation.

§ 14.02 Illegal Activity

[D] Costs—Defining "Gross Income"

Page 309, add the following

It makes no sense to permit deductions as part of cost in computing gross income if the deductions would be disallowed as expenses. Costs are just deferred expenses. The contrary argument is that cost can be deducted when it enters into the definition of gross income, because it is not (technically) a deduction.

A Committee Report, S. Rep. 97-494 (Vol.1) at 309 (1982), supports including in the cost of goods sold an amount that would not be deductible as an expense. The Report discusses the disallowance of deductions under **§280E** for expenses related to drug dealing, stating: "To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by [§ 280E]." In *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), the court noted that the government has conceded "that the disallowance of sec. 280E does not apply to costs of goods sold, a concession that is consistent with the case law on that subject and the legislative history underlying sec. 280E. *See* Peyton v. Commissioner, T.C. Memo. 2003-146; Franklin v. Commissioner, T.C. Memo. 1993-184; Vasta v. Commissioner, T.C. Memo. 1989-531."

Presumably, the constitutional problem is that refusing to increase cost of goods sold would increase gross income and that would result in taxing something that was not gross income without apportionment among the states according to population. But apportionment is required only for a direct tax and the increase in tax based on illegal drug activity appears to be an indirect excise tax, not subject to the apportionment requirement.

Chapter 15

EXEMPT REIMBURSEMENTS

§ 15.04 Exempt Reimbursements

COMMENTS AND QUESTIONS

Page 327, add the following

4. Another situation in which there can be both an exclusion and a deduction arises from **§ 139A**, which excludes from income federal subsidy payments made to a sponsor of a qualified retiree prescription drug plan. Beginning in 2013, any deduction allowable for payments by a business to these qualified plans is reduced by excludible subsidy payments.

Chapter 16

LIMITING THE INTEREST DEDUCTION

§ 16.01 Personal Loans

[C] Statutory Rules

[1] Qualified Residence Interest

Page 331, add the following

In Rev. Rul. 2010-25, 2010-2 C.B. 571, the IRS decided that indebtedness incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute "home equity indebtedness" to the extent it exceeds $1 million. For example, if a taxpayer buys a principal residence for $1,500,000, paying $200,000 in cash and borrowing the remaining $1,300,000 through a loan that is secured by the residence, $1 million is "acquisition indebtedness" and another $100,000 is "home equity indebtedness." The agency rejected a Tax Court decision adverse to the taxpayer in *Catalano v. Commissioner*, 79 T.C.M. (CCH) 1632 (2000).

[3] Student Loans

Page 332, add the following

The tax benefits for student loans have been extended through 2012 by the 2010 Tax Relief Act. For 2012, the phase-out thresholds above which the tax break begins to disappear are: single taxpayer (**$60,000**); married taxpayers (**$125,000**). These figures reflect an expansion of the student loan interest deduction, which had been scheduled to expire after 2010. In addition, the repeal of the 60-month limit on the number of months for which the interest is deductible has also been extended through 2012.

§ 16.04 Economic Reality

[B] Note on Statutory Interpretation—Tax Avoidance

Page 344, add the following

Legislating the economic substance rule. In 2010, Congress enacted an "economic substance" requirement in the Reconciliation Act amendments (Public Law 111-152) to the Patient Protection and Affordable Health Care Act. See **§ 7701(o)**, effective March 30, 2010. The statute requires a showing that a transaction changed the taxpayer's economic position in a meaningful way apart from federal income tax effects *and* that the taxpayers had a substantial purpose apart from federal income tax effects—in other words, an objective and a subjective test. The law does not apply to a taxpayer's efforts to avoid state income taxes, federal estate taxes, and foreign taxes.

Prior case law regarding the economic substance doctrine was unclear. Some cases recognized a transaction if there was *either* economic substance or a business purpose. And the Federal Claims Court had suggested that judicial use of the doctrine violated separation of powers. Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (2004), vacated and remanded, 454 F.3d 1340 (Fed. Cir. 2006).

Several features of this law cause concern:

– First, the statutory terms "meaningful" and "substantial" are unclear.

– Second, the statute is written in the conjunctive—requiring both economic substance and a business purpose.

– Third, the penalties are substantial. Tax understatements resulting from transactions that fail the statutory test will be subject to a 40% strict liability penalty if they are not disclosed by the taxpayer, 20% if there is disclosure. **§ 6662(b)(6), (i)**. There is no reasonable cause exception so opinions given by tax advisors will not prevent the penalty. **§ 6664(c)(2),(d)(2)**.

– Fourth, the method of determining the profit potential to prove economic substance and business purpose is unclear. The legislative history states that "if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit." An earlier version of the law explicitly used the low risk-free rate of return as the discount rate used to compute present value, which was a pro-taxpayer provision. (The lower the discount rate the higher the present value of the expected pre-tax profit.) The legislation that passed is silent regarding the discount rate.

For all these reasons, the IRS will undoubtedly be under considerable pressure to issue rulings that explain how the new law applies to various transactions.

The legislative history (Joint Committee on Taxation Report, JCX-18-10, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010) tries to ease some taxpayer concern by stating that the new law is not meant to change the tax rules applicable to the choice between certain economic alternatives, such as a corporation's decision to issue debt or equity or a taxpayer's decision to use either a foreign or domestic corporation to make foreign investments. In addition, the legislative history states that a transaction is not suspect if there is a congressional purpose to allow the taxpayer to take advantage of certain tax breaks—"The doctrine of economic substance becomes applicable . . . where a taxpayer seeks to claim tax benefits, *unintended by Congress*, by means of transactions that serve no economic purpose other than tax savings (emphasis added)." In other words, the new law does not eliminate the statutory interpretation question whether Congress intended to permit transactions that achieve tax savings whether or not they have nontax economic substance.

Many tax avoidance transactions are too complex to be considered in a basic tax course. However, the next chapter will consider sale-leaseback transactions and the legislative history of the

new law clearly states that "[l]easing transactions . . . will continue to be analyzed in light of all the facts and circumstances." Such transactions will therefore remain vulnerable under the economic substance test. You might also revisit the *Cottage Savings* decision (Chapter 3, § 3.03[D]), in which a taxpayer exchanged claims against one set of debtors for claims against other debtors without altering the credit risk. The taxpayer was trying to realize a tax loss, without recognizing the loss for banking regulation purposes. The Court held that there was a realized tax loss because the change in the debtors created a different legal situation for the taxpayer-creditor. But was the taxpayer's economic position changed in a "meaningful" way apart from taxes; was there a substantial business purpose apart from taxes? One way to avoid any implication that *Cottage Savings* would come out differently under the new law is to infer that a change in the timing of the recognition of gain or loss is not the kind of tax break that is suspect under the economic substance test. (The taxpayer in *Cottage Savings* had only accelerated a tax loss by changing debtors.)

You might wonder why Congress stepped in to codify the economic substance doctrine when courts had given the government several victories. One reason is that the added revenue from the statutory provision (as computed by the Congressional Budget Office when it "scores" the effect of federal legislation) can be used to offset additional expenditures in the health care reform law—thereby reducing any adverse impact on the federal budget deficit. As long as the doctrine was left to the vagaries of judicial implementation, its revenue consequences were uncertain and could not be taken into account in making budget calculations.

Chapter 17

LOANS, BASIS, AND TAX SHELTERS

§ 17.04 Tax Ownership

[B] Cases

Page 365, add the following

COMMENT

Tax-exempt seller-tenant. A question that should occur to someone examining a sale-leaseback arrangement is why the seller-tenant does not keep the property and use the deductions associated with owning the property (depreciation and interest), rather than selling the property to someone else who uses those deductions. The answer is that the seller-tenant is usually less able to use the deductions than the buyer-lessor—e.g., because it is in a lower tax bracket or has net operating losses.

In one situation, the tax law (as of 2004) prohibits a buyer-lessor from taking a deduction for depreciation and interest in excess of rent where the seller-tenant is (obviously) unable to use the deductions—that is, when the seller-tenant is a tax-exempt entity (including a government). **§ 470**.

Chapter 18

ALTERNATIVE MINIMUM TAX

§ 18.02 Mechanics

[C] Exemptions—§ 55(d)

[1] Amounts

Pages 383-384, add the following

The exemption amount is periodically increased by legislation; it is not automatically adjusted for inflation. The 2010 Tax Relief Act provides the following:

– for 2010: **$47, 450** (single); **$72,450** (married)

– for 2011: **$48,450** (single); **$74,450** (married).

[3] Kiddie Tax

Page 384, add the following

The AMT exemption amount for any child subject to the kiddie tax is limited to earned income plus **$6,950** for 2012.

[D] Credits

Page 384, add the following

The 2010 Tax Relief Act extends the ability to use nonrefundable personal credits to reduce the AMT through 2012. This includes the credit for dependent care, the child tax credit, the adoption credit, and the American Opportunity tax credit (the old Hope Scholarship credit).

§ 20.06 Case Law Limits on Capital Gains

[E] Sale of Lottery Winnings

COMMENTS

Page 425, add the following

4. The latest case to hold that the sale of lottery winnings produces ordinary income is *Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007).

§ 22.02 The Solutions

[C] Other Carve Out Situations

[2] No Statutory Provision

Page 450, add the following

The text discusses the example of a sale of a term and remainder interest in land to two unrelated purchasers and asks whether the purchaser of the term interest can depreciate the purchase price of the term interest. PLR 200852013 says that the purchaser can take depreciation, which opens up the tax avoidance potential discussed in the text. The favorable ruling is conditional on the purchase of the term interest not being funded by either the seller or the remainderman. (There is no discussion of how the purchaser of the remainder interest is treated.)

The letter ruling also states that "[i]f a taxpayer, without additional investment, splits its interest in nondepreciable property into a term interest and a remainder interest and the taxpayer retains the term interest, depreciation deductions are not allowable under section 167(a) for that term interest," citing the decision in Lomas Santa Fe, Inc.

§ 24.06 Qualified Retirement Plans

[B] No Tax Now; Taxable Later

[2] Traditional IRAs

Page 477, add the following

The $5,000 maximum annual deduction for contributions to a traditional IRA is adjusted for inflation beginning in 2009 (rounded down to the nearest $500). There is no change in the maximum deduction for 2012. For a taxpayer who *is* an active participant in a qualified retirement plan, the inflation-adjusted income phase-out range for 2012 is **$58,000-$68,000** for single taxpayers and **$92,000-$112,000** for married couples. If the taxpayer is *not* a participant in a qualified retirement plan but the spouse is an active participant, the inflation-adjusted phase-out range for 2011 is **$173,000-$183,000.**

Page 477, add the following

[5] Qualified Charitable Distributions from IRAs

Congress has grown fond of the following rule. A taxpayer aged 70 1/2 or older can distribute up to $100,000 from an IRA to a charitable organization without recognizing income and without taking a charitable deduction (thereby not using up the percentage limitation on charitable deductions). Moreover, the distribution counts toward the required minimum distribution from an IRA. This tax break was scheduled to expire after 2007 but has been extended through 2011 (but not through 2012). **§ 408(d)(8)**.

[C] Nondeductible Now; Exempt Later

[1] Roth IRAs

Page 478, add the following

For 2012, the inflation-adjusted phase-out threshold above which the tax break for contributions to a Roth IRA begins to disappear is **$110,000** for single taxpayers and **$173,000** for married couples.

Chapter 25

ACCRUAL METHOD

§ 25.01 Income

[B] When Cash Is Received

[2] Post-*AAA* Developments

COMMENTS AND QUESTIONS

Page 493, add the following

4. **Advance trade discounts**. In *Westpac Pacific Food v. Commissioner*, 451 F.3d 970 (9th Cir. 2006), the court held that "advance trade discounts" were not income when they were received but were properly treated as downward adjustments to the cost of goods sold for products purchased with such discounts. The court gave the following simplified example:

> The facts outlined below sound more complicated than they are, so imagine a simple hypothetical. Harry Homeowner goes to the furniture store, spots just the right dining room chairs for $500 each, and says "I'll take four, if you give me a discount." Negotiating a 25% discount, he pays only $1,500 for the chairs. He has not made $500, he has spent $1,500. Now suppose Harry Homeowner is short on cash, and negotiates a deal where the furniture store gives him a 20% discount as a cash advance instead of the 25% off. This means the store gives him $400 "cash back" today, and he pays $2,000 for the four chairs when they are delivered shortly after the first of the year. Harry cannot go home and say "I made $400 today" unless he plans to skip out on his obligation to pay for the four chairs. Even though he receives the cash, he has not made money by buying the chairs. He has to sell the chairs for more than $1,600 if he wants to make money on them. The reason why the $400 "cash back" is not income is that, like a loan, the money is encumbered with a repayment obligation to the furniture store and the "cash back" must be repaid if Harry does not perform his obligation.

In other words, the taxpayer could use the cash discount to reduce the cost of goods sold rather than report it as income when received, by analogy to the deposits in the Indianapolis Power case. The analogy was apt because the taxpayer had to return the discount if it did not meet its commitment to purchase goods in large volume.

The IRS has agreed to follow the *Westpac* case in Rev. Proc. 2007-53, 2007-2 C.B. 233, even though the government won a case disagreeing with *Westpac (Karns Prime & Fancy Food, Ltd. V. Commissioner*, 494 F.3d 404 (3d Cir. 2007)).

§ 25.02 Deductions

[B] Before Cash is Paid

[3] Statutory and Regulatory Solutions—Economic Performance

Page 498, add the following

7. *Gift cards as customer-refund*. There are two ways a business can provide a refund to a customer by using a gift card. First, it can provide a cash refund and sell a gift card to the customer. In that case, the cash refund is deductible when given and the proceeds from selling a gift card are deferred if they satisfy the requirements of **Treas. Reg. § 1.451-5**. Second, it can issue a gift card to the customer. In that case, there would normally be no deduction because there is no fixed liability under **Treas. Reg. § 1.461-1(a)(2)(i)**; the customer may or may not use the card. In Rev. Proc. 2011-17, 2011-5 I.R.B. 441, the IRS decided that the two ways of issuing a gift card should be treated the same way. Consequently, the issuance of a gift card *will* be deductible (like a cash refund) and the business can defer the value of the gift card if it satisfies **Treas. Reg. § 1.451-5**.

Chapter 26

PROPERTY TAX

§ 26.05 Federal Constitutional Rules

[C] Equal Protection

COMMENT

Page 515, add the following

In *USGen New England, Inc. v. Town of Rockingham*, 838 A.2d 927 (Vt. 2003), the owner of hydroelectric power plants challenged a statutory freeze in its property tax values at the 1997 level for tax years 1998-2000. The freeze occurred following the deregulation of the electrical power markets. The court upheld the freeze, as follows:

> We find that our decision in [an earlier case] controls here. That case involved a taxpayer challenge to a "rolling reappraisal" method of assessment in which every two years the town would reassess only that class of property determined by the State Tax Department to be "most in need"—i.e., where on average there was the greatest percentage discrepancy between the listed value of the properties in the class and their fair market value. The taxpayers argued [] that this "rolling reappraisal" method violated the Proportional Contribution Clause [which imposed the same standard as the federal Equal Protection Clause]. . . . [W]e concluded that the town's actions had a rational basis—"keeping appraisals as current as possible within the resources available by attacking the worst underassessment problem areas." . . .
>
> The appropriate standard of review is whether the difference in treatment between newer and older owners rationally furthers a legitimate state interest [citing Nordlinger v. Hahn, 505 U.S. 1 (1992)]. In general, the Equal Protection Clause is satisfied so long as there is a plausible policy reason for the classification, the legislative facts on which the classification is apparently based rationally may have been considered to be true by the governmental decisionmaker, and the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational. This standard is especially deferential in the context of classifications made by complex tax laws. [I]n structuring internal taxation schemes the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation. Based on this deferential standard, we have no problem concluding that the freeze is constitutional. . . .
>
> Here, the State argues that the freeze has a rational basis: ensuring temporary stability of tax revenues in a number of small Vermont towns, in the face of difficulties in determining the fair market value of hydroelectric facilities brought

> about by the "changing and deregulated utility market." We agree with the trial court that this purpose "is certainly legitimate and important, and is arguably compelling."

In *Clifton v. Allegheny County*, 969 A.2d 1197 (Pa. 2009), the court dealt with a county's indefinite use of a "stagnant" out-of-date base year market value to assess real property. The court first noted that "absolute equality and perfect uniformity are not required" and that a classification "related to any legitimate state purpose" is permissible. It also stated that the state constitution's Uniformity Clause was generally analyzed in the same way as the Equal Protection Clause of the U.S. Constitution. It then held that the use of a base year did not violate the state constitution's Uniformity Clause "on its face." Consequently, annual reassessments were not required. However, the base market year method, as applied by Allegheny County, did violate the Uniformity Clause because of its indefinite duration and because the municipalities in the county experienced varying rates of appreciation and depreciation over a prolonged period. The court also noted that "lower-value neighborhoods where property values often appreciate at a lower rate than in higher-value neighborhoods" were at a special disadvantage.

§ 26.06 Valuation Methods

[D] Specific Problems

[1] Prestige Buildings

Page 520, add the following

But see *First Federal Sav. & Loan Ass'n of Flint v. City of Flint*, 329 N.W.2d 755 (Mich. 1982):

> The law does not tax expenditures that merely enhance the image or business of the owner, only expenditures that add to the cash value or selling price of the property. It can be anticipated that, if a bank puts fine hardwood and marble throughout a building, those expenditures may not enhance the selling price of the building in an amount equal to their cost. While the expenditures may add to the selling price of the building, they may not add dollar-for-dollar.

[2] Property Subject to Burdens

[c] Easements

[i] Additive Approach

Page 522, add the following

In *Breezy Knoll Association, Inc. v. Town of Morris*, 946 A.2d 215 (Conn. 2008), the court dealt with the tax on property owned by a homeowners association—specifically: common areas adjacent to homes owned by the association's resident members. The homeowners had an easement of passage and use over the common areas, which consisted of tennis courts, a parking lot, and a

lakefront strip. The court concluded that the easements should reduce the property tax value of the common areas (the servient property) and increase the value of the adjacent homes (the dominant estate), which is consistent with the additive approach. The court rejected the argument "that the question of whether to assess the value of the commonly used properties against either an association or its members is merely a semantic one," noting that if "the value properly attributable to the homeowners' properties [is instead] attributed to association properties, it deprives the homeowners of the benefit of a deduction, for federal income tax purposes, of the property taxes the homeowners effectively are responsible for paying."

The court also noted that "the enhancement to a dominant property and the devaluation of a servient property caused by an easement are not necessarily equivalent," which is *not* consistent with the implication of the additive approach that the adjustments in the value of the servient and dominant property should be symmetrical.

The court relied on a similar result reached in *Lake Monticello Owners' Assn. v. Ritter*, 327 S.E.2d 117 (Va. 1985), and *Waterville Estates Assn. v. Campton*, 446 A.2d 1167 (N.H. 1982).

Chapter 27

ESTATE AND GIFT TAX

§ 27.02 Gift Tax

[C] Exclusions

Pages 526-27, add the following

The inflation-adjusted gift tax exclusion amount is **$13,000** for 2012.

Chapter 28

SOCIAL SECURITY TAX

§ 28.01 In General

Page 539, add the following

The inflation adjusted maximum earnings subject to the social security tax for 2012 is **$110,100**.

The Patient Protection and Affordable Health Care Act (Public Law 111-148) provides a tax on "unearned income" to help fund Medicare, beginning in 2013. "Unearned income" refers to investment income, such as interest (not counting the tax exempt interest on state and local bonds), dividends, capital gains, royalties and rents, unless any of these items is derived from a trade or business. The tax is 3.8% of the lesser of (1) net investment income or (2) modified adjusted gross income in excess of $200,000 for an individual and $250,000 for a married couple. These threshold amounts reflect President Obama's pledge not to raise taxes on individuals with lesser amounts of income. For example, assume an individual has $180,000 of wages, $45,000 of unearned income, and modified adjusted gross income of $215,000. The 3.8% tax would be imposed on $15,000 (the lesser of $215,000 minus $200,000; and $45,000).

The Patient Protection and Affordable Health Care Act (Public Law 111-148) also increases the Medicare tax by 0.9% beginning in 2013—from 1.45% to 2.35%—on an employee's wages and on the earned income of a self-employed individual above a threshold of $200,000 (for an individual) and $250,000 (for a married couple). The earned income of a married couple in excess of $250,000 that is subject to the additional .9% tax refers to the combined earnings of both spouses. This is a departure from the usual practice of imposing Social Security taxes based on the separate earnings of each spouse. These thresholds are not indexed for inflation.

For 2011, the employee portion of the Social Security tax is lowered to 4.2% and the tax paid by self-employed individuals is reduced from 12.4% to 10.4%—as a stimulus to consumer spending. Congress extended this tax cut through the end of 2012.

§ 28.02 Wages

[B] Severance Pay for Teachers

COMMENTS AND QUESTIONS

Page 544, add the following

4. The Third Circuit has now followed the Sixth Circuit decision in *Appoloni* and held that early retirement payments to tenured faculty are wages subject to FICA taxation. University of Pittsburgh v. U.S., 507 F.3d 165 (3d Cir. 2007). There was a dissent.

§ 28.03 "Employee"

[A] Common Law Standard

[2] Applying the Factors

Page 554, add the following

[e] Massage Therapists

In *Mayfield Therapy Center v. Commissioner*, 100 T.C.M. (CCH) 376 (2010), the court considered whether massage therapists were employees or independent contractors. The following expansive excerpt illustrates how fact specific these determinations are. The court stated:

> Ms. Mayfield is a licensed massage therapist. During 2002 she operated the therapy center and a massage school at separate locations in Ardmore, Oklahoma. . . . The facilities at each location included a reception area in the front and workstations for cosmetologists and nail technicians. (Hereinafter we refer to the cosmetologists and nail technicians collectively as cosmetologists and sometimes refer to the cosmetologists, nail technicians, and massage therapists collectively as service providers.) . . .
>
> The service providers received no set salary or wages and no fringe benefits. As a general rule, the spa charged each service provider weekly "booth rent" equal to the greater of approximately $80 "base rent" or 25 percent of the gross revenues the service provider generated that week. But the spa's practices varied. . . . The service providers set their own hours. Some of them worked full time; others were part-time workers who were students or had jobs elsewhere. . . . Petitioners had written agreements with some service providers, at least for some years at issue, but not with others. . . . [S]ervice providers without written agreements generally gave the spa advance notice of the days and hours they planned to be at the spa. But the service providers often altered their schedules as they chose and were free to leave the spa during the hours they had scheduled for themselves. . . .
>
> Clients made appointments for spa services at the receptionist's desk. A receptionist or Ms. Mayfield generally answered the telephone, or if they were unavailable, one of the service providers would answer it. If the client requested a particular service provider, the request was honored. If the client requested no particular service provider, the receptionist would rotate scheduling among available service providers. A service provider could decline servicing any particular customer. . . . The spa posted prices for various spa services on brochures and on its Internet site. But the service providers were not required to charge these posted prices; they often charged less and occasionally provided free services for repeat customers, family, and friends.

. . . The service providers sometimes got together and designed “specials”, which were then offered by the spa. Ms. Mayfield started the practice of offering her clients a card that gave them a free massage after 10 paid massages for a certain rate. Some of the other massage therapists also offered this card, but others decided not to offer it. The spa also sold gift certificates and offered “spa parties”, sometimes offsite, at which spa services were provided to a group of customers for a single price, invoiced by the spa and divided among the participating service providers. A service provider's participation in “spa parties” was voluntary. . . .

Each [service provider] generally provided her own supplies . . . . Some types of supplies, such as massage oils, the massage therapists generally purchased from the spa, which bought them in bulk. They sometimes bought other supplies from outside sources. Each massage therapist generally had an assigned room. In at least some instances, the massage therapists decorated and fitted out their assigned rooms with massage tables, lamps, shelves, stereos, and other items procured at their own expense. . . . Massage therapists are required to have a license from the City of Ardmore. Cosmetologists are required to have a State license. The service providers paid for their own training school, licenses, and continuing professional education. Many of the massage therapists initially received their training from the massage school Ms. Mayfield operated. These students paid the regular fees charged by the massage school, and there was no guarantee or obligation that massage school students would work at the spa after graduation. . . .

Each week the spa would prepare payout sheets for the service providers. These payout sheets listed each service provider's clients and the total amount that each client paid for services rendered. From these amounts the spa would deduct booth rent, expenses for products the service providers might have purchased from the spa, and any amount that the service provider might have taken from the basket money. Each week, the spa would write the service providers checks for the net amounts due them. . . .

. . . Petitioners contend [] that respondent improperly classified the service providers (i.e., the massage therapists and cosmetologists) as employees. . . . Respondent acknowledges that the spa's payout arrangement is “something of a hybrid” since it includes both a percentage split of gross revenues and a “minimum rent component”. But respondent contends that this “minimum rent component” demonstrates “more control over the workers rather than less.” If [] as the Commissioner's revenue rulings suggest, a fixed rent arrangement evidences self-employment status (since employees do not normally pay their employers rent for their workspace), we have difficulty understanding how a fixed rent component in a percentage payout formula weakens, rather than strengthens, the case for self-employment status. . . . We take this circumstance into account as one factor weighing against an employer-employee relationship.

The weekly payment arrangement also reflected, in addition to the spa's retention of rent, compensation of the service providers on a straight commission

basis, with no minimum guaranteed level of payment. This circumstance also counts in favor of independent contractor status, as does the fact that the spa provided the service providers no employee benefits, such as vacation or sick leave.

Respondent concedes that the spa did not pay service providers' business or travel expenses and that this circumstance supports independent contractor status. In addition, it appears that many of the massage therapists made significant investments in outfitting and decorating their massage rooms. These various circumstances, coupled with the spa's right to collect minimum fixed rent each week, also lead us to conclude that service providers bore the risk of suffering net losses, and in some weeks did suffer net losses, from their operations at the spa. Conversely, the service providers had opportunities to profit by working longer hours, at times coming into the spa for appointments outside the spa's normal business hours. Finally, on the basis of the testimony of several service providers, it appears that they believed that they had a nonemployee relationship with the spa. All these considerations support a finding of independent contractor status.

Other factors also point to independent contractor status. Respondent concedes that the spa did not tell the service providers how to provide their services to the clients. In fact, it appears that the spa required the service providers to comply with only a relatively small number of instructions relating to the spa's operation. The service providers were all licensed professionals, possessing skills as required by their licensing. They set their own hours. Although they provided the spa with their schedules in advance, they changed those schedules as they pleased. And although the spa posted operating hours and attempted to have coverage for all those hours, the service providers were not required to work those hours, and the spa sometimes closed early if no service provider was available to work. Moreover, the service providers might work in the spa outside the posted hours, gaining access to the spa with their own keys. Although the spa posted prices for various services, the service providers were free to charge less and sometimes provided services for free. Similarly, although the spa promoted various “specials”, the service providers were free to decide whether they wished to participate. And although the spa assigned walk-in clients on a rotating basis, the service providers retained the right to refuse any client.

Arrayed against these considerations supporting independent contractor status are a number of factors supporting employee status for the service providers. In particular, their services were integrated into the spa's operations; they provided their services mostly, if not entirely, on the spa's premises; the spa provided at least some informal training to new service providers; there is no showing that the service providers made their services available to the general public (other than by working at the spa) regularly and consistently; they were assisted in booking appointments and in receiving payments by receptionists that the spa employed and supervised; clients paid the spa rather than the service providers; and the spa retained the payments until it distributed the service providers' weekly checks.

Other factors we consider neutral or of limited usefulness to our analysis. For instance, although there was no requirement that the service providers work full time for the spa, and although some of them in fact worked part time and had jobs elsewhere, these circumstances appear consistent with either independent contractor or part-time employee status. Likewise we regard as neutral the fact that the service providers rendered their services personally—a circumstance probably dictated by the nature of the services and the licensing requirements.

Respondent asserts as a factor evidencing an employer/employee relationship that petitioners had the right to terminate the services of any service provider at any time and that any service provider could terminate his or her relationship with the spa at any time. But we are not persuaded that this consideration adds much to our analysis, particularly given the informal nature of the relationship between the spa and its service providers. It may, however, help explain what appears to have been a significant level of turnover among the service providers, many of whom operated at the spa for only a short time. That consideration, in turn, leads us to think that although some other service providers operated at the spa for several years, the work relationship was not necessarily permanent or indefinite, as indicative of employment status. Consequently, we also regard this factor as neutral.

Although this is a close case, weighing all the evidence we conclude that factors indicating the service providers' autonomy predominate over factors indicating petitioners' control over them. Accordingly, we conclude and hold that the service providers were independent contractors rather than petitioners' employees during the years at issue.

[B] Employer's Consistent and Reasonable Treatment as Non-Employee

Page 555, add the following

In *Peno Trucking, Inc. v. Commissioner*, 2008 U.S. App. LEXIS 27686 (6th Cir., Oct. 3, 2008) (not selected for publication), rev'g, 93 T.C.M. (CCH) 1027 (2007), the court held that the Tax Court did not err in finding that truckers were employees, but concluded that the employers avoided liability for Social Security taxes under the safe harbor provisions of § 530 of the Revenue Act of 1978.

Page 555, add the following

[C] Are Medical Residents Eligible for "Student" Exception?

In *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), the Court dealt with a Treasury Department rule interpreting the Social Security Act. That Act exempted from taxation "service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." The Treasury regulations exempted students whose work was "incident to and for the purposes of pursuing a course of study." In 2004, the Treasury replaced its

case-by-case application of this standard with a rule that categorically excludes from the student exemption a "full-time employee," defined in all events as an employee "normally scheduled to work 40 hours or more per week." The issue was whether this regulation could be applied to deny an exemption for medical residents who have graduated from medical school and train for a specialty. These doctors are required to engage in formal educational activities but spend most of their time (50 to 80 hours per week) caring for patients. The Court concluded that Congress had not directly addressed this precise question because it did not define "student" or consider how to deal with medical residents. Consequently, it deferred to the Treasury regulation under the Chevron case (discussed in Chapter 6.02).

§ 29.03 Tax Base

[B] Primarily Tangible Personal Property

[5] Progressivity

Page 560, add the following

In *Sparks Nugget, Inc. v. State ex rel. Dept. of Taxation*, 179 P.3d 570 (Nev. 2008), the court was asked to decide whether the state constitution's exemption for "food for human consumption" applied to the purchase of *uncooked* food by a Nevada casino followed by its preparation and complimentary provision to selected customers and employees. The court held that "the constitution's plain language clearly and broadly exempts *all* food for human consumption (unless that food is 'prepared food intended for immediate consumption' at the time it is sold)." It contrasted the Nevada exemption with an Arizona provision that explicitly limited its food exemption to sale of food for home consumption. It rejected the government's argument that the food was subject to the use tax as "prepared food intended for immediate consumption," because the taxpayer prepared the uncooked food; it did not purchase food already prepared.

§ 29.04 Taxable Sales of Tangible Personal Property

[B] Tangible or Intangible Property

Page 566, add the following

COMMENT—"COMMON UNDERSTANDING"

In *City of Boulder v. Leanin' Tree, Inc.*, 72 P.3d 361 (Colo. 2003), the taxpayer (Leanin' Tree) manufactured and sold greeting cards and other gift products which contained images of original artwork created by independent artists. The taxpayer entered into license agreements with the artists, borrowing their original artwork or its photographic or digital image and receiving the exclusive right to reproduce and publish the images. The taxpayer then transformed the image from its original size into a product-usable size for its greeting cards or other products and routinely added borders or verse or both, changed the contrast of the image, and often changed the composition of the image by adding or deleting elements in the image, and frequently cropped the image to best fit the product. The derivative image was then burned onto metal plates, after which the original artwork was returned to the artist. The court applied the "common understanding" test in concluding that the taxpayer was acquiring intangible property, as follows:

> Whether couched in terms of the true object, dominant purpose, or essence of the transaction, or of the consequential or incidental nature of the transfer of

> tangible property, the rationales of most courts attempting to characterize inseparably mixed transactions acknowledge, either explicitly or implicitly, that they are not reducible to a single, dispositive factor. While there has been no clear emergence of a comprehensive and consistent theory that more expressly articulates the goals of the analysis, a veritable plethora of factors have been relied on under the circumstances of individual cases. . . .
>
> Varied as these analyses may be, they largely share in common some attempt to identify characteristics of the transaction at issue that make it either more analogous to what is reasonably and commonly understood to be a sale of goods, or more analogous to what is generally understood to be the purchase of a service or intangible right. Perhaps the quintessential transaction for the purchase of an intangible right is the marketing of literary works, in which the clear object, around which the entire transaction is structured, is the right to publish the author's work. Although the transactions by Leanin' Tree may superficially appear to be akin to the purchase of artwork, which is normally considered to be the sale of a tangible object, upon closer examination the transactions between Leanin' Tree and its artists have much more in common with a transaction for the right to publish.

However, in *Cinemark USA, Inc. v. Seest*, 190 P.3d 793 (Colo. Ct. App. 2008), the court interpreted the state's use tax on tangible personal property to apply to a movie theater's acquisition of the right to exhibit motion picture films to the public. Unlike in Leanin' Tree, the product was used by the movie theater in precisely the form in which it was received and was not an idea that could be used in a different form than conveyed. The transaction was more like the purchase of a work of art (clearly a taxable event) than payment for the intangible component of the film. And the copyright in the movie was of little value without the film reels. Consequently, "the totality of circumstances show[ed] that the essence of [the] transaction [was] the use of motion picture reels, tangible final products, for exhibition in [the taxpayer's] movie theater."

[C] Some Illustrative Cases

[2] Tangible vs. Intangible Property

COMMENTS

Page 573, add the following

5. *Electricity*. In *Exelon Corp. v. Illinois Dept. of Revenue*, 917 N.E.2d 899 (Ill. 2009), the court held that sale of electricity was the sale of tangible personal property. It relied heavily on how scientists understood electricity, stating:

> The record in the present case contains the unrebutted affidavit and report of Dr. Fajans, entitled "The Physical Nature of Electricity." He defined electricity as the flow of electrons in a circuit. Dr. Fajans explained: "Electricity is physical and material because, microscopically, it consists of the flow and 'pressure' of a material entity, namely electrons, and macroscopically, it can be sensed (felt, tasted, seen, and

> heard), measured, weighed, and stored, and is subject to universal laws of nature." Dr. Fajans elaborated as follows: "Without electrons, electricity cannot be transmitted. Though electrons themselves are very small and lightweight, they are one of the basic constituents of matter; common matter like hydrogen or ion consists of electrons, protons, and neutrons in roughly equal number. Recently, scientists have been able to see electrons, or more precisely, the density of electrons, with devices called Scanning Tunneling Microscopes. . . . There is nothing more physical and material than an electron. Since electricity itself consists of the flow of a material object, electricity is physical and material." . . .
>
> We now join the several courts that have expressly held in varying contexts that electricity constitutes "tangible personal property." See, e.g., Searles Valley Minerals Operations, Inc. v. State Board of Equalization, 160 Cal.App.4th 514, 521, 72 Cal.Rptr.3d 857, 862 (2008); Narragansett Electric Co. v. Carbone, 898 A.2d 87, 97-98 (R.I.2006); Davis v. Gulf Power Corp., 799 So.2d 298, 300 (Fla.Dist.Ct.App.2001); Curry v. Alabama Power Co., 243 Ala. 53, 59-60, 8 So.2d 521, 526 (1942).

Because this decision departed from some obiter dictum in a prior case, it was made prospective.

Query. How would a "common understanding" approach describe the sale of electricity.

§ 29.05 Use Tax and Constitutional Law

[B] Collection Problems—Interstate Issues

COMMENTS

Page 579, add the following

3. Some out-of-state sellers have tried to avoid a "substantial nexus" with the purchaser's state by authorizing independent contractors to handle some of their online sales. New York passed a law requiring the out-of-state seller to collect a use tax in this type of situation (if New York gross receipts from such sales exceeded $10,000) and a lower court upheld such a tax on Amazon.com. Amazon.com LLC v. New York State Dept. of Taxation and Finance, 877 N.Y.S.2d 842 (Sup. Ct. 2009). The law stated that

> a person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller . . .. This presumption may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus

requirement of the United States constitution during the four quarterly periods in question.

The New York rules specify that the out-of-state seller is not subject to this law if it includes in its agreement a condition that in-state commissioned representatives are prohibited from engaging in solicitation activities in New York on its behalf.

The court described the arrangement between Amazon and the independent contractor as follows, resulting in a finding that New York could constitutionally require Amazon to collect use tax on sales to New York purchasers.

> Amazon created an "Associates Program," which allows participants ("Associates") to maintain links to Amazon.com on their own websites and compensates them by paying "a percentage of the proceeds of the sale." Amazon also offers incentives to Associates that "directly refer" customers to its Amazon Prime program through website links, paying them a "$12 bounty" for each new enrollee. Prospective Associates must apply to join the program. Assuming that Amazon accepts the application, the parties enter into an Operating Agreement, which makes clear that the "Relationship of [the] Parties" is that of "independent contractors." Associates are granted "a revocable, non-exclusive, worldwide, royalty-free license . . . solely for purposes of facilitating referrals from [their sites] to the Amazon Site." Amazon authorizes Associates to place different types of links from their websites to its own. For example, Associates can set up a "product link," generally allowing them to "select one or more Products [on Amazon's site] to list on [their own] site," a "search box link," which permits visitors to the Associate's site to view Amazon merchandise related to their queries, or a "cart link," which "when clicked will allow visitors [of the Associate's site] to add products to their shopping cart and/or purchase products via [Amazon's] 1-Click feature."
>
> . . . The Operating Agreement [] sets forth that Associates will be paid through a "referral fee" and can elect between the "Classic Fee Structure" (generally 4% of qualifying revenues from sales of products sold through special links) or the "Performance Fee Structure" (a percentage of qualifying revenues set forth in a table that varies with the number of total items shipped). Amazon has hundreds of thousands of Associates. Thousands "of them have provided Amazon with addresses in New York." Sales to New York customers originating from New York-based Associate referrals constitute less than 1.5% of Amazon's New York sales. Without disclosing the dollar amount of those sales, Amazon simply acknowledges that its "Associates Program generates more than $10,000 per year in sales to customers located in New York."

The court stated:

> In Scripto v. Carson, 362 U.S. 207 (1960) [] the United States Supreme Court held that a State could require tax collection by an out-of-state company that had contracts with 10 in-state residents-deemed "independent contractors"—who solicited

orders for products on its behalf. The agreement with the contractors provided that they were to be paid by commission and salespeople sent orders out of state for fulfillment. In contrast, if the only connection with the State is solicitation from out of State—through catalogs, flyers, advertisements in national periodicals or telephone calls-and delivery of merchandise to customers by common carrier or use of mail, there is an insufficient nexus for taxation purposes (see Quill Corp. v. North Dakota, 504 U.S. 298 (1992). So long as there is a "substantial nexus" with the taxing State, the taxes that must be collected need not derive from the seller's in-state activity (National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977) [nonprofit society required to collect taxes from California mail-order customers based on maintenance of two offices in California from which advertising was solicited for its monthly magazine]). . . .

Amazon urges that the statute would bring within its ambit "simple advertising by in-state advertisers." The Commission-Agreement Provision, however, does no such thing. It imposes a tax-collection obligation on sellers who contractually agree to compensate New York residents for business that they generate and not simply for publicity. Amazon has not come close to refuting the Tax Law's presumed constitutionality and the statute must be upheld.

Amazon maintains that it lacks a substantial nexus with New York and that its Associates' activities are insufficient to justify imposition of New York tax-collection obligations. It argues that it has no physical presence in New York and that its Associates have no role in its sales transactions, which are completed out-of-state. Amazon emphasizes that its Associates "are mere advertisers who do not solicit sales at Amazon's behest" and that they are not "traveling salesmen"—they do not necessarily personally solicit sales from New York residents. It asserts that all its Operating Agreements provide for is placement of links on Associates' websites.

Amazon further states that Associates' referrals to New York customers are not significantly associated with its ability to establish and maintain a market for sales in New York because they account for less than 1.5% of its New York sales. Amazon complains that "it is practically impossible" for it to determine with certainty which of its Associates are New York residents and then to disprove solicitation.

None of these allegations, however, sufficiently state a claim for violation of the Commerce Clause. Amazon contracts with thousands of Associates that provided it with a New York address. Certainly, if Amazon were to have a dispute with any of them, it could easily ascertain New York residency for purposes of a lawsuit. All of the information is publicly available. Indeed, there is no reason that the Associates application, which Amazon may accept or reject, cannot inquire about New York resident status.

It does not matter, moreover, that Associates do not solicit New York business at Amazon's direct behest or that Amazon contractually prohibits them from engaging in certain limited specified conduct such as offering its customers money

back for Amazon purchases made through Associate links. Amazon chooses to benefit from New York Associates that are free to target New Yorkers and encourage Amazon sales, all the while earning money for Amazon in return for which Amazon pays them commissions. Amazon does not discourage its Associates from reaching out to customers or contributors and pressing Amazon sales.

Amazon has not contested that it contracts with thousands of New Yorkers and that as a result of New York referrals to New York residents it obtains the benefit of more than $10,000 annually. Amazon should not be permitted to escape tax collection indirectly, through use of an incentivized New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities.

The Amazon.com decision was affirmed on appeal with a modification. 913 N.Y.S.2d 129 (N.Y.A.D. 2010). The court held that the law did not violate the Commerce Clause on its face, but remanded for further discovery on whether the law violated the Commerce Clause as applied. The court stated:

The first of the "as-applied" arguments to be addressed is the claim that the statute violates the Commerce Clause. Plaintiffs argue that since their representatives do nothing more than advertise on New York-based Web sites, the statute cannot be applied in a constitutional manner. Inasmuch as there has been limited, if non-existent, discovery on this issue we are unable to conclude as a matter of law that plaintiffs' in-state representatives are engaged in sufficiently meaningful activity so as to implicate the State's taxing powers, and thus find that they should be given the opportunity to develop a record which establishes, actually, rather than theoretically, whether their in-state representatives are soliciting business or merely advertising on their behalf. Although, as noted above, the advisory memoranda describe a process by which the representatives can certify that they do not solicit, the possibility remains that many of the in-state representatives could certify that they are not soliciting, and, yet, the Department of Taxation and Finance (DTF) could find that the activities in which they are engaged do constitute solicitation. Additionally, it is within the realm of possibility that the DTF could find that purported out-of-state representatives are actually located in-state by virtue of misrepresenting their address. It would also afford plaintiffs the opportunity to establish the bona fides of their other claims, such as whether it is impossible to identify who their in-state representatives are (even though plaintiffs presumably need an address to which to send, inter alia, any commission checks).

We are also unable to determine on this record whether the in-state representatives are engaged in activities which are "significantly associated" with the out-of-state retailer's ability to do business in the state, as addressed in Tyler Pipe Indus., Inc. v. Washington State Dept. of Revenue, 483 U.S. 232, 250 (1987). In an affidavit from its vice-president, Amazon represents that, in 2007, its sales to New York State residents referred by Associates which provided Amazon with New York addresses upon registration constituted less than 1.5% of its total sales to New York

State residents. It argues that this revenue is not "significantly associated" with its ability to do business in New York. Whether plaintiffs can meet their burden on this issue remains to be seen, but we cannot, on this record, make a determination.

§ 33.03 Preventing Double Taxation

[B] Subchapter S Election

Page 619, add the following

Although the more-than-2% shareholder-employee in a Subchapter S corporation cannot exclude medical insurance premiums from income, this shareholder is treated as a partner. Consequently, this shareholder can take advantage of the 100% deduction for such premiums available to partners under **§ 162(*l*)(1)(A)**. The shareholder reports the amount of the premium paid by the S corporation as wage income and then deducts the premium in computing adjusted gross income. *See* Notice 2008-1, 2008-2 I.R.B. 251.

An attempted Social Security ploy. Taxpayers sometimes try to use Subchapter S corporations to avoid Social Security tax. Here is what they try to do. A person whose income is derived from personal services (such as lawyers) organizes a Subchapter S corporation and receives a portion of the profits as salary, subject to Social Security tax. The rest of the income will be distributed by the corporation as a "dividend" and, the taxpayer hopes, this will not be considered wages. This technique can always be reviewed to recharacterize the dividend distribution as wages. In *Watson, P.C. v. United States*, 714 F. Supp. 2d 954 (S.D. Iowa 2010) (accountant), the court recharacterized the entire distribution as wages.

§ 33.06 Contributions to Capital

[B] Contribution in Nonshareholder Capacity

[1] Taxable

Page 625, add the following

In *AT & T, Inc. v. United States*, 629 F.3d 505 (5th Cir. 2011), the issue was "whether the plaintiff-taxpayer, AT&T Inc., an interstate telecommunications company, must pay income taxes on the funds it received from federal and state governmental entities for providing 'universal service'—viz., affordable telephone service mainly for lower-income consumers and those in high-cost rural, remote or isolated areas—or else is entitled to treat those funds as nonshareholder contributions to capital under the Internal Revenue Code, see 26 U.S.C. § 118(a)."

The court quoted from the Supreme Court's test for applying **§ 118(a)** in *United States v. Chicago, Burlington & Quincy Railroad Co*., 412 U.S. 401 (1973):

> [1] [The payment] must become a permanent part of the transferee's working capital structure. [2] It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. [3] It must be bargained for. [4] The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. [5] And the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

And, from a review of Supreme Court cases, it derived the following principles:

> (1) Whether a payment to a corporation by a non-shareholder is income or a capital contribution is controlled by the intention or motive of the transferor. (2) When the transferor is a governmental entity, its intent may be manifested by the laws or regulations that authorize and effectuate its payment to the corporation. (3) Also, a court can determine that a transfer was not a capital contribution if it does not possess each of the first four, and ordinarily the fifth, characteristics of capital contributions that the Supreme Court distilled from its jurisprudence in CB&Q. Applying these principles to the facts of this case, we conclude that, either by construing the controlling statutes and regulations or by applying the CB&Q five-factor test, the governmental entities in making universal service payments to AT&T did not intend to make capital contributions to AT&T; and thus, that the payments were income to AT&T.

The court concluded (1) that AT & T had failed to show that it had bargained for the payments "rather than simply having accepted the unilaterally imposed law and regulations determining the [] payments"; (2) that the payments "were paid to AT&T to compensate it for providing certain specific services"; and (3) that "AT&T fail[ed] to demonstrate that the payments it received from the federal and state [governments] became a permanent part of AT&T's working capital structure . . . ."

Chapter 34

INTERNATIONAL TAXATION

§ 34.01 Taxing the Worldwide Income of "Residents"

[B] Avoiding Double Tax; Foreign Tax Credit (FTC)

[1] Mechanics; Limitation on FTC

[b] Different Baskets

Page 637, add the following

As of 2007, there are only two baskets for determining the FTC limitation—a general basket (typically, business income) and a passive income basket. (Beginning on August 10, 2010, there is a third basket, explained below.) The passive income basket consists of income that is easy to shift to low tax jurisdictions—such as interest, dividends, rents and royalties. Financial services income (e.g., income earned by banks and insurance companies) and rents and royalties earned from an active trade or business are placed in the general basket. The idea is to prevent the taxpayer from averaging high-taxed business income with low-taxed passive income in order to reduce the foreign tax on foreign income to less than the U.S. tax on foreign income. For example, a 40% foreign tax on $100 of foreign business income and a 10% foreign tax on $100 of foreign passive interest income averages out to a 25% foreign tax on $200 of foreign income (50/200). That is less than the U.S. corporate tax rate, which exceeds 30%.

There is also a "high-tax kickout," which places highly taxed passive income into the general basket. This prevents averaging low-taxed passive income with highly-taxed passive income. A common example of income subject to the high-tax kickout is rent, which is taxed on a net income basis by the United States but is taxed on a gross basis by the foreign country. For example, assume $100 gross rent, $50 expenses to produce the rent, and a 25% foreign tax on the $100 of gross rent. The foreign tax is $25, which equals 50% of the $50 of net income, as calculated under U.S. law.

Finally, income taxed by a foreign country which is not considered income under U.S. law is placed in the general basket. **§ 904(d)(2)(H)**. An example is a distribution by a foreign corporation that is not taxable to its U.S. shareholders by the United States because the corporation lacks earnings and profits, but which is taxable as a dividend by the foreign country in which the corporation resides for tax purposes. This provision may have been adopted to reduce the opportunity for a taxpayer to average a foreign tax on which no U.S. tax is due against a low foreign tax on passive income subject to U.S. tax. Nonetheless, placement in the general basket still allows taxpayers to average a high foreign tax on income not taxed by the United States against a low foreign tax on business income subject to U.S. tax. Consequently, in spring, 2009, the Obama administration proposed that there be no foreign tax credit for a foreign tax on income not subject to U.S. tax. This is one of a number of proposals to close loopholes in the taxation of foreign income that is intended to raise significant revenue.

New FTC basket. Effective for tax years beginning after August 10, 2010, there is a new separate FTC basket for income that would be U.S. source income under U.S. law but is resourced as foreign income under a tax treaty. **§ 904(d)(6)**. Typically, this would occur by shifting interest or dividend income to a foreign branch. The idea is to prevent use of the tax treaty to inflate the numerator used to compute the foreign tax credit limitation.

[2] More Mechanics

[a] Carryovers

Page 638, add the following

Under current law, unused tax credits can be carried back one year and forward ten years. **§ 904(c).**

[c] Foreign Losses

Page 638, add the following

The law now provides a tax break in the converse of the situation covered by **§ 904(f)(1)**. Instead of having U.S. income and a foreign loss in year 1, assume a $100 U.S. loss and $100 of foreign income in year 1 (subject to a $25 foreign tax). In that case, there is no FTC in year 1 because there is no U.S. tax despite having paid a foreign tax . In year 2, the taxpayer has $100 of U.S. income subject to U.S. tax and no foreign income. Over the two year period, total U.S. income is zero and foreign income equals $100. **§ 904(g)(1)** allows this taxpayer to treat 50% of the U.S. income in year 2 as foreign income (equal to $50), thereby using some of the unused $25 FTC carried forward from year 1.

Page 639, add the following

[5] Check-a-Box and the Foreign Tax Credit

The check-a-box regulations (Chapter 33, § 33.04) provide an opportunity for U.S. taxpayers who would not otherwise be eligible for the indirect foreign tax credit to obtain a foreign tax credit. For example, assume a U.S. corporation owns less than 10% of the stock of a foreign business entity; 10% ownership is required for the U.S. corporation to obtain the indirect foreign tax credit provided by **§ 902.** If the foreign entity is not considered a "per se" corporation under U.S. law, it can elect pass-through status. Its foreign taxes will therefore be treated as directly paid by its shareholders (including an 8% shareholder) and will be eligible for the direct foreign tax credit. At the same time, the foreign country may treat the entity as a corporation, eligible for whatever legal and tax advantages that might provide under foreign law. These entities are known as "hybrid entities"—treated one way under U.S. law and another way under foreign law.

§ 34.02 Taxing Nonresidents on Income Arising within the Taxing Jurisdiction

[A] Effectively Connected with a U.S. Trade or Business

[5] Treaties

[a] Business Income; Permanent Establishment

Page 643, add the following

A capital-importing country may rely on a more expansive definition of a permanent establishment than would be true for the United States or Europe—in order to tax more income earned by foreign branches of a U.S. business than might otherwise be the case. For example, India has indicated that leasing tangible or intangible property for use in India might (under certain circumstances) constitute a permanent establishment. This diverges from the position taken in the model tax treaty adopted by the European-based Organization for Economic Cooperation and Development (OECD). *See* Tax Notes Int'l 238-39 (Jan. 19, 2009).

Another important issue concerns whether the location of high speed servers to conduct very fast investment trading transactions in a particular country constitutes a permanent establishment (PE). Under the OECD Model Tax Treaty, the issue is whether the server is a "fixed place of business." The Commentary to the OECD Treaty says that, if the server is "at [the taxpayer's] own disposal," the server *could* be a PE. The National Tax Authority of Japan has stated that a foreign investor using a server located in Japan does *not* have PE in Japan because the investor does not have the "right to dispose of" or have "virtual control over" the server beyond "receiving and enjoying an environment for high-speed placement of orders." See Tax Notes International, p. 485 (Nov. 14, 2011). Before a taxpayer is too comforted by this ruling, it must take note of numerous qualifications --for example: the investor does not own or lease the server; the investor cannot use the server at its discretion except to execute high-speed transactions; and the investor cannot enter the space where the server is installed.

[B] Nonbusiness Investment Income

[1] Interest Income

Page 644, add the following

Beginning in 2011, the 80-20 rule is repealed. Consequently, interest paid by a U.S. corporation will be U.S. source income even if the U.S. corporation has 80% foreign source income.

[2] Dividends

Page 644, add the following

The U.S. no longer imposes a tax on dividends paid by a foreign corporation to foreign shareholders when at least 25% of its gross income is U.S. business income. The "branch profits" tax

imposed on the foreign corporation's U.S. business income is considered a sufficient method of taxing such income.

§ 34.03 Undertaxing International Income

[B] Intercompany Pricing

Page 646, add the following

The effort to identify "comparable" transactions when you are dealing with controlled entities is theoretically flawed, because there are gains that result from integrated businesses that do not exist in transactions between unrelated businesses. Nonetheless, the United States rules (as well as the OECD Guidelines) require a comparison of transactions between related and unrelated parties to determine the "correct" pricing. Two broad approaches are taken: methods based on specific transactions; and methods that allocate the total profits of the controlled entities. The methods based on specific transactions include:

– comparable uncontrolled price method (CUP) (focusing on the price charged by one related entity to another related entity); CUP is favored if the transactions are more or less identical.

– resale price method (RPM) (comparing the gross profit margin earned in sales of products purchased from a related entity with the gross profit margin on sales of products purchased from an unrelated entity); used most often when a related distributor sells finished products without providing significant value added).

– cost plus (comparing gross profit margins in transactions between related and unrelated business); used most often to determine the mark-up when manufacturers sell to related parties.

The Regulations (somewhat unhelpfully) require the taxpayer to use the best method, and then specify that this method will be determined by the degree of comparability between the transactions and the quality of the data. Comparability is judged by (among other things) the functions performed by the businesses engaged in the transactions; the contractual terms; the risks undertaken; and the economic conditions. When transactions are not comparable, an effort is often made to adjust the price arrived at by a particular method to account for whatever feature is not comparable, such as the existence of bulk sales in one but not the other situation.

The most contentious issues arise with intangibles (such as copyrights, patents trade names, and business methods). Thus, licensing arrangements that attempt to attribute royalty payments to a low tax country are subject to close scrutiny. Two Code sections explicitly state that the royalties paid between two related businesses—often after a transfer of the intangible to a foreign country—shall be adjusted so that they are commensurate with the income attributable to the intangible. **§§ 367(d), 482 (last sentence)**. This prevents a U.S. taxpayer from transferring an intangible to a related foreign corporation in a low tax jurisdiction and charge a low royalty, claiming that the profit potential is not very great, followed by significant profits from exploiting the intangible. The cited

sections force a recasting of the royalty payment in light of actual income so that the income of the U.S. taxpayer is more than the amount specified in the royalty contract.

Another important issue concerns how to allocate the deduction of research and development (R&D) costs—e.g., between the country where the costs were incurred and to the country where sales income has been generated by the R&D. A complex set of regulations now deal with this issue; **Treas. Reg. § 1.871-17**.

Another problem raised by R&D (as well as other intangibles) is the compensation that should be paid to the developer of the intangible for its use by related businesses. One way taxpayers try to avoid this problem is to enter into cost-sharing arrangements whereby related entities (e.g., U.S. and foreign corporations) each contribute to the development of the intangible. **Treas. Reg. § 1.482-7** explains when the IRS will recognize a cost-sharing arrangement, so that no adjustment of income between the related parties will be required under **§ 482**.

As the text indicates, the uncertainties involved in transfer pricing may lead taxpayers to avoid controversy by seeking advanced pricing agreements (APAs). In an unusual twist, GlaxoSmithKline argued that the IRS illegally discriminated by denying it an APA when it had entered into an APA with a competitor. In September, 2006, GlaxoSmithKline and the government agreed to the largest settlement ever reached with the IRS ($3.4 billion) to resolve transfer pricing claims. As part of the settlement, the taxpayer also withdrew its discrimination claim.

Finally, disputes about transfer pricing are (obviously) very controversial, uncertain in outcome, and involve a lot of money. The IRS has recently issued Schedule UTP (Uncertain Tax Position) (Announcement 2010-75), requiring business taxpayers with assets exceeding $100 million to report UTPs with their tax return beginning in 2010. This requires businesses to report income tax positions to the IRS for which businesses have recorded a reserve in a financial statement audited by their accountants. Transfer pricing issues must be separately highlighted by the letter "T" on the Schedule UTP.

[C] Tax Havens

[2] Typical Tax Haven Income

[a] Foreign Base Company Sales Income

Page 647, add the following

Treasury Regulations effective July 1, 2009 expand the situations in which a CFC will be considered to have participated in the "manufacture, production or construction" of a product for sale, thereby expanding the situations in which a CFC will *not* have foreign base company sales income (FBCSI). The Regulations include situations in which employees of the CFC make a "substantial contribution" to the manufacture, production, or construction of the product; they also seek to accommodate the growing practice of producing goods through use of a contract manufacturer. **Treas. Reg. § 1.954-3(a)(4)(iv)**. Examples flesh out the new rules.

Examples 1 and 2 specify that "[m]ere contractual rights to control materials, contractual rights to oversee and direct the manufacturing activities or process pursuant to which the property is manufactured, and ownership of intellectual property are not sufficient" to avoid characterization as FBCSI. However, the CFC will not have FBCSI if it actually exercises its right "to oversee and direct the [manufacturing] activities" of the contract manufacturer.

Example 10 deals with situations in which the CFC purchases raw materials and designs the products manufactured by the contract manufacturer, and manages manufacturing costs and capacities. Although the products "can be manufactured from the raw materials to [the CFC's] design specifications without significant oversight and direction, quality control, or control of manufacturing related logistics," the CFC has sufficient participation through its employees for the sales income to avoid FBCSI characterization.

[c] Foreign Personal Holding Company Income

[iii] Section 954(c)(6); Temporary Provision (2006-2008)

Page 649, add the following

Section 954(c)(6) has been extended through 2011 (but not 2012).

[E] More on Investment Income

Page 649, add the following

The imputation of income from a foreign personal holding company (owned by a few individuals) to its shareholders has been repealed—as of 2005.

Page 649, add the following

[F] "Foreign Tax Credit Splitting Event"

Public Law 111-226, effective beginning in 2011, adds a new **§ 909** to prevent taxpayers from taking a foreign tax credit before they take the income into account, *if* there is "a foreign tax credit splitting event." Subsection (d)(1) provides the following definitions:

> (d) Definitions.—For purposes of this section—
>
> (1) Foreign tax credit splitting event.—There is a foreign tax credit splitting event with respect to a foreign income tax if the related income is (or will be) taken into account under this chapter by a covered person.
>
> . . .
>
> (3) Related income.—The term "related income" means, with respect to any portion of any foreign income tax, the income . . . to which such portion of foreign income tax relates.

(4) Covered person.—The term "covered person" means, with respect to any person who pays or accrues a foreign income tax (hereafter in this paragraph referred to as the 'payor')—

(A) any entity in which the payor holds, directly or indirectly, at least a 10 percent ownership interest (determined by vote or value),

(B) any person which holds, directly or indirectly, at least a 10 percent ownership interest (determined by vote or value) in the payor,

(C) any person which bears a relationship to the payor described in section 267(b) or 707(b), and

(D) any other person specified by the Secretary for purposes of this paragraph.

Here are two examples of the impact of **§ 909**. First, a U.S. corporation controls two business organized in foreign country X. One business is a "disregarded entity"—such as a partnership in country X; another business in country X is a controlled foreign corporation (CFC). The CFC has $100 of income subject to a $30 foreign income tax. Under the laws of country X, the disregarded entity is liable for the tax. This means that the $30 tax would be treated as having been paid by the U.S. corporation which controls the partnership, even though the income in the CFC had not been distributed to the U.S. corporation. **Section 909** disallows the foreign tax credit for this $30 payment until the related income is distributed to the U.S. corporation.

Second, a foreign corporation is wholly owned by a U.S. corporation, such that the foreign corporation's income tax payments would be attributable to the U.S. corporation when the U.S. corporation receives a dividend. However, the foreign corporation is a "reverse hybrid," – that is, an entity that is considered a pass–through entity under the laws of the foreign country. Consequently, the income of the foreign entity is attributed to the U.S. corporation which controls the foreign entity and a tax is imposed by that foreign country on the U.S. corporation, even though the foreign entity is considered a U,.S. corporation under U.S. law and, consequently, none of the foreign entity's income is attributed to the U.S. corporation under U.S. law. The income of the foreign entity and the foreign tax have been split and the foreign tax paid the U.S. corporation is not eligible for the foreign tax credit until the foreign entity's income is taxed to the U.S. corporation (e.g., when it is distributed as a dividend).

Chapter 35

INTERSTATE TAXATION

§ 35.02 Federal Constitutional Limits

[A] Introduction; The Due Process/Commerce Clause Framework

[2] Constitutional Requirements—Connection; Nondiscrimination

Pages 654-55, add the following

The Supreme Court has been asked to decide whether the physical presence test in Quill applies outside of the sales and use tax context, but has so far refused to review such a case. *See, e.g.*, Dell Catalogue Sales L.P. v. Taxation and Revenue Department, 199 P.3d 863 (N. Mex. 2008) (gross receipts tax imposed on out-of-state seller based solely on in-state activities of third-party contractor providing post-sale services to in-state buyers), *cert. denied*, 129 S. Ct. 1616 (2009); Capital One F.S.B. v. Commissioner of Revenue, 899 N.E.2d 76 (Mass. 2009) (for income-based taxes, the proper constitutional test is the *Complete Auto* "substantial nexus" standard, not the *Quill* "physical presence" standard), *cert. denied*, 129 S. Ct. 2827 (2009); Geoffrey, Inc. v. Commissioner, 899 N.E.2d 87 (Mass. 2009) (same), *cert. denied*, 129 S. Ct. 2853 (2009).

[B] Fair Apportionment

[1] Income Tax; Unitary Business

Page 663, add the following

COMMENT ON ADD BACK OF ROYALTY PAYMENTS

In *Surtees v. VFJ Ventures, Inc.*, 8 So. 3d 950 (Ala. Civ. App. 2008), aff'd, *Ex parte VFJ Ventures, Inc.*, 8 So. 3d 983 (Ala. 2008), *cert. denied*, 129 S. Ct. 2051 (2009), the Alabama court dealt with one technique used by several states to prevent businesses from shifting income to a low tax state. Somewhat simplified, the tax avoidance problem and the state response are as follows. A taxpayer transfers intangible assets (usually a trade-mark) to a subsidiary corporation organized in a low tax jurisdiction (often in Delaware, but North Carolina in this case). It then pays a royalty to the subsidiary corporation for use of the intangible asset (the trade-mark). The royalty is deducted from income in the higher-tax state, thereby lowering the taxpayer's net income subject to apportionment. Alabama requires the taxpayer to add back into income the royalty payment unless it is otherwise subject to a tax in Alabama or in the payee jurisdiction (e.g., Delaware or North Carolina).

Before reaching the constitutional issue, the court made two preliminary observations. First, Alabama does not rely on the following technique for dealing with this problem—combining the income of the two corporations as a unitary business. Second, the "subject to tax" exception to the

add back rule did not apply. Although North Carolina taxed the royalty as income subject to its apportionment rules, the amount of royalty income subject to apportionment in that state was very low—0.0019% and 0.0027% of federal taxable income in the case of two North Carolina subsidiaries. The court said that this did not amount to taxation of the royalty payment by North Carolina under Alabama's "subject to tax" exception.

The taxpayer argued that the state's add back rule was, in effect, an effort by Alabama to tax the North Carolina subsidiaries on the royalty income on the theory that there was a sufficient nexus between the subsidiaries' activities and the state of Alabama. As you recall, most (but not all) of the cases have refused to apply the *Quill* "physical presence-substantial nexus" analysis to an income tax. However, the Alabama court did not rely on this argument, perhaps because the U.S. Supreme Court has not yet decided this issue. The Alabama court held instead that the constitutionality of the add back should be analyzed as though it were Alabama income of the Alabama parent corporation.

The court went on to hold that "the evidence did not demonstrate that the application of the add-back statute has resulted in taxation [by Alabama] that is out of proportion to [the Alabama corporation's] activities in [Alabama]." The court did little to explain why that was so. It would appear that the same argument that would allow Alabama to tax the North Carolina corporation's royalty income would justify the conclusion that the income was fairly included in the Alabama corporation's income in the first place through the add back technique—specifically, that Alabama could constitutionally lay claim to taxing the royalty.

[C] Discrimination

[1] Gross Receipts Tax

Page 669, add the following

The text states that the Court's decision in the Kentucky case relied on the "market participation" test to permit Kentucky to exempt interest on bonds issued by its government units. In fact, that position commanded only a plurality. The majority position relied on the fact that the bonds were issued for a traditional government function, leaving open the question whether "private activity" bonds (e.g., for housing and stadiums) could also receive the same discriminatory tax break.