PARTNERSHIP CURRENT DEVELOPMENTS

Section: FIN48 FASB Gives Go Ahead to Private Company Reporting Under FIN48..... 1

Section: Tax Forms IRS to Stop Mailing Paper Tax Packages to Taxpayers.................. 1

Section: 61 Taxpayer Not Relieved of Reporting Her Share of Rental Income Just Because Her Son Had Reported It All.. 2

Section: 108 Treatment of §108(i) Debt Issues for S Corporations and Partnership Issued by IRS 2

Section: 108 Debt Secured by Single Member LLC Holding Only Real Estate Can Qualify for Qualified Real Property Business Indebtedness...................................... 4

Section: 311 Transfer to Family Partnerships from Corporation for Valid Nontax Reason Did Not Trigger Taxable Distribution Despite Valuation Issues.................................. 5

Section: 469 Required Disclosures under §469 for Grouping of Activities Outlined by the IRS.. 6

Section: 469 LLC Members are Not Automatically Treated as Passive Under the Limited Partner Rule of §469... 7

Section: 475 IRS Grants Late 475(f) Relief to Partnership That Failed to Recognize a Technical Termination Had Ended Prior Election 8

Section: 704 §704(c) Anti-Abuse Rules Added by IRS to Regulations............................ 8

Section: 705 Taxpayer's Initial Victory on Option Loss Generating Partnership Reversed by Tenth Circuit.. 9

Section: 705 Basis Calculation is a Cumulative and Not Year by Year Calculation When Applying "Not Below Zero" Limit Found in §705(b) 10

Section: 707 Transfer of Subsidiary to Partnership Was a Disguised Sale 10

Section: 707 Investors Were Actually Partners, and There Was Not a Disguised Sale of State Tax Credits 11

Section: 707 Transfer of Assets to Partnership Followed by Pledge of Interest to Receive Nonrecourse Loan and Related Put Held to Be Disguised Sale 12

Section: 736 Payments to Retiring Partner Were Ordinary Income Despite Misreporting by Partnership.. 13

Section: 752 Court Finds Absolutely No Chance of Reasonable Profit from Son of BOSS Transaction and Disallows Tax Benefits Claimed 14

Section: 752 Son-of-BOSS Transaction Found to Lack Economic Substance, so Issue of Retroactive Application of Reg. §1.752-6 Not Relevant. 15

Section: 754 IRS Grants Permission to Make Late §754 Election After Four Years of Returns Filed 16

Section: 1031 Exchange Had Principal Purpose of Tax Avoidance, Deferral of Gain Not Allowed 17

Section: 2036 Merely Showing Donor Had a Retained Life Estate Not Sufficient to Bring Entire Value of Transferred Property Into Donor's Estate 18

Section: 2036 Transfer to Partnership Found to be Bona Fide Sale for Full and Adequate Consideration, Partnership Assets Not Required to Be Included in Decedent's Estate 19

Section: 2036 Transfer to Family Limited Partnership Was Bona Fide Sale, and Thus Value of Stock Not Includable in Transferor's Estate 20

Section: 2503 Gifts of Partnership Interests Were Not Present Interests 20

Section: 2503 Fresh from Affirmation in Christiansen, Tax Court Rules Use of Formula Clause for Gift Split Between Charities and Others Did Not Violate Public Policy ... 21

Section: 2512 Taxpayer's Claimed Gift of Partial Interest and Sale of Remaining Interest in LLC Held to Be Single Bargain Sale Under Step Transaction Rules.................... 22

Section: 2512 Check the Box Rules Do Not Apply to Valuation of Interest in Single Member LLC 23

Section: 2512 Gifting Partnership Interests Before Transferring Assets Removes Valuation Discounts for Gifts.. 23

Section: 2518 Eighth Circuit Rules a Fractional Disclaimer Does Not Violate Public Policy 24

Section: 6015 Tax Court Has No Relief to Offer Innocent Spouse Prior to Resolution of Partnership's TEFRA Case 25

Section: 6226 Federal Circuit Agrees With D.C. Circuit That Partners Basis in Shelter Transaction is an Affected Item, Not a Partnership Item.. 26

Section: 6226 Tax Court Had Jurisdiction to Determine Partnership a Sham, But Not to Determine Affect on Individual Partners' Basis 26

Section: 6229 Fees Paid Related to Son of BOSS Partnership Transaction Transaction Billed to S Corporation Nevertheless Is An Affected Item 27

Section: 6231 Items Affecting Nonpartners Not Affected Items Nor Properly Handled Via TEFRA Procedures 27

Section: 6231 Designation of a Tax Matters Partners on a 1065 By Partnership Otherwise Exempt from Unified TEFRA Procedures Does Not Serve As Election to Have Procedures Apply 28

Section: 6231 IRS Required to Issue Notice of Deficiency if No Partnership Item is Changed, but Error Was Harmless 28

Section: 6331 Partners Draws Are Subject to IRS Levy on Wages 29

Section: 6404 Interest Abatement Properly Denied When TMP for Partnership Ceased Cooperating, Even Though Binding Agreement Existed on Resolving Case 30

Section: 6501 IRS Regulations Applying Six Year Statute to Large Overstatement of Basis Held Invalid by Tax Court 31

Section: 6501 IRS, After Losing in Court, Revises Regulations to Redefine an Overstatement of Basis as Creating an Understatement of Income Under §6501(e)(1)(A) 32

Section: 6662 Corporation's Reliance on Opinion Letter From CPA Firm Involved In Structuring Transaction Not Reasonable, Penalties Applied 33

Section: 6662 Accuracy Related Penalty and Excessive Claim for Refund Penalties Will Apply to Amounts Attributable to Transactions Lacking Economic Substance 34

Section: 6662 IRS Outlines Adequate Disclosure for Purposes of §6662 and §6694 ... 34

Section: 6698 & 6699 Penalties Increased Dramatically for Late Filed Partnership or S Corporation Returns 35

Section: 7422 Characterization of Transaction as Sham a Partnership Item, Statute of Limitations Defense Not Available to the Individual Partners in Refund Action 35

Section: 7422 IRS Settlement Did Not Amount to Concession on Sham Transaction Doctrine or That Sham Transaction Issue Not a Partnership Item 36

Section: 7701 Late Request For Automatic Relief Under Rev. Proc. 2009-41 Should Result in Change Effective Exactly 3 Years and 75 Days Prior to Date of Request 37

Section: 7701 Economic Substance Doctrine Codified 37

Section: 7701 IRS Liberalizes Relief for Late Entity Elections Under Check the Box Rules... 39

SECTION: FIN48
FASB GIVES GO AHEAD TO PRIVATE COMPANY REPORTING UNDER FIN48

Citation: ASU 2009-06, Income Taxes, 9/2/09

After a couple of delays, the Financial Accounting Standards Board gave the go ahead for the implementation of the measurement and disclosure requirements of FIN48 to private companies (or "nonissuers" in the current parlance) and passthrough entities, effective for annual statements with an ending date after December 31, 2009. The FASB did make some modifications found in Accounting Standards Update 2009-06 in the final requirements.

The ASU did remove some disclosure requirements for nonpublic entities. Such entities will not be required to disclose a tabular reconciliation of uncertain return positions, nor would they prepare a summary of exposures that would change the effective tax rates. However the other measurement and disclosure requirements of FIN48 will apply to such entities.

Firms should be readying procedures to handle FIN48 compliance for clients that require GAAP compliant statements. Firms should also consider the potential impact on their independence of any assistance tax practitioners render to the client's accounting staff in assembling the information necessary to comply with FIN48, specifically considering issues related to nonattest work covered by Ethics Interpretation 101-3.

SECTION: TAX FORMS
IRS TO STOP MAILING PAPER TAX PACKAGES TO TAXPAYERS

Citation: IRS e-News for Tax Professionals 2010-40, 9/25/10

One of the standard events that mark each new year will be no more. The IRS announced in e-News for Tax Professionals issue 2010-40 that the IRS will cease mailing tax packages to either individuals or businesses. In early October the IRS will send a postcard to individuals that filed a paper return for 2009 and to businesses that normally receive tax packages to inform them that the forms will no longer be mailed to them.

The postcard will explain how taxpayers may obtain such paper forms and the instructions for such forms in the future. The IRS cited the growth of electronic filing as the reason why the IRS is taking this step at this time. It would appear the IRS believes by making it a bit of a nuisance to obtain paper forms that it's likely a number of individuals still filing returns on paper will instead use electronic filing.

SECTION: 61
TAXPAYER NOT RELIEVED OF REPORTING HER SHARE OF RENTAL INCOME JUST BECAUSE HER SON HAD REPORTED IT ALL

Citation: Conway v. Commissioner, TC Summary Opinon 2010-27, 3/8/10

Patricia Conway admitted she co-owned a rental property with her son, and did not dispute a Form 1099MISC in her name that reported $5,619 of rental income in her name. But she argued her son had received and reported all of the rental income on his return, therefore she shouldn't have to report the income on her return.

The Tax Court disagreed, holding that rental income must be taxed to the owner of the property at the time it is paid regardless of whether or not her son had actually received the payments. To hold otherwise, the Court held, would violate the assignment of income doctrine.

SECTION: 108
TREATMENT OF §108(I) DEBT ISSUES FOR S CORPORATIONS AND PARTNERSHIP ISSUED BY IRS

Citation: TD 9498, 8/11/10

The IRS issued temporary and proposed regulations outlining the application of the §108(i) cancellation of debt income deferral provisions as they apply to partnerships and S corporations.

Unlike C corporations where the rules apply to all debt, for a partnership or S corporation the rule only applies to what is referred to as an "applicable debt instrument." An "applicable debt instrument" generally is a debt instrument issued by the partnership or S corporation in connection with the conduct of a trade or business. While the regulations hold that this determination is based on all facts and circumstances, five safe harbor tests are provided where the debt will be treated as issued in connection with the conduct of a trade or business. Meeting any of the five tests will cause the debt to be treated as an "applicable debt instrument."

1. At the date of issuance of the debt instrument, the gross fair value of the trade or business assets of the entity represented at least 80% of the gross fair value of the entity's total assets;

2. For the taxable year of issuance, the trade or business expenditures of the entity represented at least 80% of the entity's total expenditures for the year in question;

3. For the year of issuance at least 95% of the proceeds of debt instruments are traceable to trade or business assets under the interest tracing rules of §1.163-8T;

4. At least 95% of the proceeds from the debt instrument were used by the entity to acquire one or more trades or businesses within 6 months of the date the debt was issued; or

5. The entity issued the debt instrument to a seller of the trade or business to acquire the trade or business. [Reg. §1.108(i)-2T(d)(1)]

While COD income must be allocated in accordance with the standard §704 rules for a partnership, after the amount has been allocated among the partners, the partnership can designate what portion of each partner's COD income is subject to the election and which portion is not. [Reg. §1.108-2T(b)(1)] For an S corporation, the COD income is shared prorata among the shareholders that are shareholders immediately before the reacquisition of the debt. [Reg. §1.108-2T(c)(1)]

Basis generally is not adjusted for either a partner nor an S corporation shareholder on the deferred COD income until the income is taken into income by either the partner or shareholder. However, for purposes of §752 special rules apply, and for purposes of capital account maintenance deferred items are treated as if no §108(i) election had been made.

There are rules in the regulation to prevent the election under §108(i) from triggering recapture of losses under §465(e). The decrease in amount at risk is not taken into account until such time as the amount is recognized in income by the partner or shareholder.

Acceleration events are addressed in the regulations. These are events that trigger the early recognition of the COD income. There are separate triggers that can apply to the entity as a whole, or those that apply to individual partners or shareholders.

The following events at the entity level would trigger an acceleration event for all direct and indirect interest holders: 1) liquidation of the entity, 2) sale, exchange, transfers or gifts of substantially all of the entity's assets, 3) cessation of business by the entity or 4) filing a petition in a bankruptcy or similar case. As well, for an S corporation the termination of the S election is an acceleration event under the regulations.

Substantially all of the entity's assets is defined to mean assets representing at least 90% of the fair value of the entity's net assets and at least 70% of the fair value of the entity's gross assets. Special rules are provided for partnership transfers subject to §721 where subsequent transactions result in dispositions.

At the individual partner level, the following items will be treated as acceleration events: 1) death or liquidation of the partner, 2) sale, exchange, transfer or gift of all or a portion of the partners' interest, 3) redemption of the partner's interest or 4) abandonment of the partner's interest. Events 1, 2 or 4 in the context of an S corporation will cause an S corporation shareholder to have an acceleration event.

If only a portion of an interest is sold, exchanged, transfers or gifted, only a proportionate amount of the COD deferral is triggered.

Certain events are not treated as acceleration events. Transfers under §721 (tax free contributions to a partnership) are generally excluded, as are like kind exchanges under §1031 though for the latter the receipt of boot will be considered in determining what proportion of assets were sold. Technical terminations of a partnership under §708(b) are also not treated as acceleration events.

The regulations apply to applicable debt instruments reacquired in taxable years ending after December 31, 2008.

SECTION: 108
DEBT SECURED BY SINGLE MEMBER LLC HOLDING ONLY REAL ESTATE CAN QUALIFY FOR QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

Citation: PLR 200953005, 12/31/09

The taxpayers had a loan that was secured by their interest in a single member LLC, an LLC formed solely to hold a piece of real estate and which is treated for tax purposes as a disregarded entity. The taxpayers are negotiating to refinance that indebtedness. The real estate securing that debt has declined in value and the taxpayers believe that some of the debt will end up being cancelled as part of the refinancing operation. They sought a ruling from the IRS that even though the debt is secured by the LLC interest rather than directly by the real estate, the reduction in indebtedness would still be able to qualify as qualified real property business indebtedness under §108(c)(3)(A).

The IRS ruled that the existence of the LLC as a disregarded entity means that the property is treated as being owned directly by the taxpayer. The ruling notes that it would “incongruent” to pay attention to the LLCs for purposes of determining whether the debt is secured by real property when that LLC is otherwise disregarded for federal tax purposes. The IRS therefore held that merely having the property titled in the name of the LLC, and then having the interests pledged against the debt, did not remove the ability for such a debt to qualify for treatment as qualified real property business indebtedness under §108(c)(3)(A).

Therefore, if the debt otherwise meets the requirements, the debt cancellation could be excluded from income and the basis of the property reduced. Since, for environmental liability concerns, a number of property acquisitions have been structured in this form (many times at the behest of the lender), this ruling gives comfort that this technicality will not remove such real estate related debt from the potential relief provisions of §108(c)(3)(A).

SECTION: 311
TRANSFER TO FAMILY PARTNERSHIPS FROM CORPORATION FOR VALID NONTAX REASON DID NOT TRIGGER TAXABLE DISTRIBUTION DESPITE VALUATION ISSUES

Citation: Cox Enterprises, Inc. v. Commissioner, TC Memo 2009-134, 6/9/09

In this case, a corporation had attempted to sell off two television stations but was only able to actually sell one. The corporation was under pressure by various lenders to get out of the television business, so it decided to contribute the remaining television station to a partnership it would enter into with the family that controlled the corporation. The family would contribute significant cash to the partnership for the interests the family would obtain.

The idea had been to have the family give an amount that would equalize the value per unit for each interest holder. However, due to an inadvertent mistake the corporation was determined to have received interests worth $60.5 million less than the value of the assets it had contributed. The family made cash contributions four year later when the mistake was discovered to correct the shortfall.

The IRS claimed that the shortfall had created a constructive dividend to the family shareholders at formation of the partnership. The Tax Court disagreed, holding that clearly the reason behind the transfer was not to move wealth to the family, but rather to rid the corporation of a business it no longer wanted, as well as to assure the employees at the television station that the family was committed to the continued operation of the station. Thus the court refused to hold there had been a constructive dividend to the Cox family.

SECTION: 469
REQUIRED DISCLOSURES UNDER §469 FOR GROUPING OF ACTIVITIES OUTLINED BY THE IRS

Citation: Revenue Procedure 2010-13, 1/6/10

The IRS in Revenue Procedure 2010-13 outlined required disclosures to be made when a taxpayer groups activities under Reg. §1.469-4 for purposes of the passive loss rules. The new disclosures will apply to taxable years beginning on or after January 25, 2010—or, for calendar year taxpayers, calendar year 2011.

In the first year a taxpayer groups two or more business activities as one, the taxpayer must attach a statement to the return disclosing the names, addresses and, if applicable, employer identification numbers of the trade or business activities or rental activities that are being grouped as a single activity. As well, the statement must contain a declaration that the grouping constitutes an appropriate economic unit for purposes of measuring gain or loss under §469. The taxpayer must also file a similar statement with the return for any year where a new activity is added to the group.

If the taxpayer regroups activities under Reg. §1.469-4(e)(2) because it is determined the taxpayer's original grouping was clearly inappropriate or a material change has occurred that makes the original grouping clearly inappropriate, the taxpayers makes a disclosure of the same items noted above plus an explanation of why the regrouping was determined to be inappropriate or the nature of the material change that made the grouping inappropriate.

A taxpayer will not need to make a disclosure compliant with this ruling for groupings that existed before the effective date of the ruling unless a change occurs in the grouping.

Partnerships and S corporations don't comply with the above rules, but must comply with the disclosure requirements for reporting activities separately to interest holders via the holders' K-1s.

If a taxpayer fails to report, the taxpayer can make the report with the return for the year the taxpayer discovers the omission. However, if the failure is discovered by the IRS on examination, the taxpayer must show reasonable cause for failure to make the proper disclosure.

SECTION: 469
LLC MEMBERS ARE NOT AUTOMATICALLY TREATED AS PASSIVE UNDER THE LIMITED PARTNER RULE OF §469

Citation: Garnett v. Commissioner, 132 TC No. 19, 6/30/09 and Thompson, Ct. Fd. Clms, 7/20/09

The IRS has lost a series of cases this year attempting to stake out the position that under §469(h)(2), as interpreted by Reg. §1.469-5T(e)(1) and (2), LLC members who hold interests in entities taxed as partnerships that pass out losses must treat those losses as passive regardless of how active they are in the underlying business. The IRS attempted to rely on language in Reg. §1.469-5T(e)(3)(i)(B) that states that a person will be treated as a limited partner if the individual's liability is limited under law to a fixed amount. Additionally, the IRS argued that the "key factor" in being a limited partner is the fact that an individual has limited liability.

The Tax Court disagreed in Garnett. The Tax Court noted that despite that language, the regulation continued on at Reg. §1.469-5T(e)(ii) to override that treatment if the limited partner is also a general partner in the partnership. To the Tax Court, the key issue for purposes of §469 is how active the taxpayer is in the entity, suggesting that historical limits on a limited partners' ability to participate in an activity was the real reason why Congress included the automatic passive treatment for limited partners.

The IRS fared no better in the Court of Claims—in Thompson that court similarly was not persuaded that "LLC member" must be equated with "limited partner" for purposes of §469. Nor did a second try at the Tax Court prove any more fruitful for the IRS. In Precourt v. Commissioner, TC Memo 2010-24 issued on February 16, 2010 the Court found the managing member of a California LLC was not automatically to be treated as a limited partner for purposes of the passive activity rules.

SECTION: 475
IRS GRANTS LATE 475(F) RELIEF TO PARTNERSHIP THAT FAILED TO RECOGNIZE A TECHNICAL TERMINATION HAD ENDED PRIOR ELECTION

Citation: PLR 201043030, 10/29/10

The IRS actually uncovered conditions under which it would allow a taxpayer to make a late election under Section 475(f) to mark to market its trading securities. In this case, the taxpayers in question were three partnerships. Due to market turmoil, most likely at the end of 2008, the partnerships were restructured.

This restructuring created technical terminations of the partnerships under Section 708. One of the side effects of a technical termination is the loss of most elections of the prior partnership. The partnerships in this case did not realize that their old elections under Section 475(f) were no longer valid.

Normally, the IRS does not grant late election relief in this area. The election generally must be filed early in the tax year in which it is first to apply. However, in this case because all parties had always been using the mark to market method for trading securities, the IRS decided that granting this request did not amount to allowing the taxpayers to use hindsight to change their method or select the method.

While the taxpayers were able to get relief in this case, we need to note first that generally such relief will not be available under Section 475(f) and it illustrates yet one more potential danger of failing to recognize that a technical termination under section 708 has taken place for a partnership.

SECTION: 704
§704(C) ANTI-ABUSE RULES ADDED BY IRS TO REGULATIONS

Citation: Final Regulations §1.704-3, TD 9485, 6/8/10

The IRS has added anti-abuse provisions to the regulations under §704(c). Generally §704(c) governs allocations related to the difference between the basis of property and that property's fair value upon contribution to the partnership. Reg. §1.704-3 provides for three methods to be used to handle such matters, but the IRS has become concerned about the possibilities for what they see as abuses of these rules.

Revisions to Reg. §1.704-3, effective for tax years beginning after June 9, 2010, provide first that the methods found in Reg. §1.704-3 apply only to contributions of property "otherwise respected," specifically noting that under Reg. §1.701-2 a contribution transaction may be recast to, in the view of the IRS, avoid tax results inconsistent with the intent of Subchapter K.

Second, a specific §704(c) anti-abuse rule is added at Reg. §1.704-3(a)(10) to provide that a method selected, even if one of those outlined earlier in §704(c) regulations, will be deemed to be not reasonable if the contribution of property and allocation of tax items are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liabilities, considering both direct and indirect partners.

SECTION: 705
TAXPAYER'S INITIAL VICTORY ON OPTION LOSS GENERATING PARTNERSHIP REVERSED BY TENTH CIRCUIT

Citation: Sala v. United States, CA10 No. 08-1333, 7/23/10

One of the few taxpayer victories in the various marketed tax shelters that used offsetting options to generate a tax loss due to the position that contingent liabilities would not be counted as liabilities for a contribution to a partnership was the Sala case. The operative word now is was—on appeal, the Tenth Circuit reversed the District Court's holding in the Sala case, finding that the transaction in question lacked economic substance.

The Court of Appeals first found the District Court erred by looking an entire five year investment program rather than concentrating on the single part of the transaction that created a large loss that the taxpayer conceded was created intentionally as part of the transaction.

The Court of Appeals also faulted the District Court for finding that the partnership transaction that took place in the year in question had a profit potential if held for a year, noting that that profit potential was minimal compared to the tax benefit that would be created, and that the loss could only be created if the partnership were liquidated prior to the end of the year. Thus, the panel held, even if the transaction showed evidence that holding it to maturity would generate the largest possible gain, the need to generate the tax loss would require the partnership to be immediately liquidated.

For that reason, the Court held, the claimed loss had to be disregarded because the transaction lacked any true economic substance—the transaction existed solely to generate a $24 million loss on demand.

SECTION: 705
BASIS CALCULATION IS A CUMULATIVE AND NOT YEAR BY YEAR CALCULATION WHEN APPLYING "NOT BELOW ZERO" LIMIT FOUND IN §705(B)

Citation: Leblanc v. United States, Court of Federal Claims, 1:05-cv-00743, 12/4/09

What does IRC §705(b) mean when it says, in computing partnership basis, that the amount will not go below zero? The taxpayer in this case claimed that it means that a taxpayer's basis gets reset to zero at that point, and any losses passed out in excess of that amount will never apply in computing basis. That was important because, in the taxpayer's case, the partnership later passed out amounts of income prior to the taxpayer's eventual abandonment of their interest, and they claimed a loss based on a calculation that added in that later income while ignoring a large first year loss that was in excess of their basis at the time.

The IRS disagreed, arguing that basis is a cumulative calculation as envisioned by §705, and the §705(b) stopping basis at zero only served as a temporary "hold" at that point until the cumulative calculation brought the basis above zero. If the IRS's position was correct, the taxpayer's basis in the activity would have been zero at the date of abandonment, and thus there would be no loss to deduct.

The Court of Claims agreed with the IRS's view, noting that if the taxpayers were correct, wildly different results would be obtained had that loss year been the final rather than first year of the partnership.

SECTION: 707
TRANSFER OF SUBSIDIARY TO PARTNERSHIP WAS A DISGUISED SALE

Citation: Canal Corporation v. Commissioner, 135 TC No. 9, 8/5/10

The Tax Court ruled that an attempt by a corporation to defer taxation of gain on the sale of its subsidiary by contributing it to a partnership ran afoul of the disguised sale rules of §707(b). In this case the corporation wished to exit a particular industry that was conducted by a subsidiary. However, the corporation wished to avoid a direct sale of the subsidiary since its tax basis in the subsidiary was low.

The corporation consulted with an investment bank and the CPA firm which served as its independent auditor. The bank and CPA firm determined that the tax on a disposition would be deferred for up to 30 years if the subsidiary contributed its assets to an LLC along with the acquiring entity contributing its own similar, but much smaller, operation in the same entity. The LLC would borrow funds from a third party, guaranteed by the acquiring entity, that would be distributed to the subsidiary. In the end the old owner would end up with a 5% interest in the partnership even though it had contributed the vast majority of the assets. So far, that looked like a textbook disguised sale.

However, the accounting firm suggested that the sale treatment would be avoided if the subsidiary indemnified the acquiring company in a limited fashion on the debt. The acquiring company itself did not require or seek the indemnity, rather it was undertaken to be able to allocate the debt entirely to the subsidiary under the debt allocation rules of §752, and escape the default treatment under the disguised sale rules.

The IRS objected that the indemnification was effectively a sham and should be disregarded under the anti-abuse provisions of Reg. §1.752-2(j)(1). Specifically, the indemnity, in addition to not being required by the buyer, did not require the subsidiary to maintain any minimal amount of capital, was placed in the subsidiary specifically to limit the maximum liability to the parent and the transaction was reported as a sale for accounting purposes. The Tax Court agreed with the IRS position, treating the transaction as a disguised sale to be reporting in the year of formation of the LLC.

SECTION: 707
INVESTORS WERE ACTUALLY PARTNERS, AND THERE WAS NOT A DISGUISED SALE OF STATE TAX CREDITS

Citation: Virginia Historic Tax Credit Fund v. Commissioner, TC Memo 2009-295, 12/22/09

Partnerships were set up in Virginia to engage in the rehabilitation of historic buildings, supported by a state tax credit. The state law provided that the credits could be (and were expected to be) allocated specially to various partners of the partnership. These limited partners, while deemed to own a small portion of the project and to be allocated a small portion of the income or loss, were told not to realistically expect any significant amount of income or loss to be allocated to them. As well, the partners agreed that the general partner could buy their interests for fair market value once the partnership had fulfilled its purpose.

The IRS argued on the one hand that the limited partners were not truly partners or, in the alternative, that their contribution of capital was a disguised sale of the state tax credits under §707.

The Tax Court ruled first that the entities were partnerships. The Court found that the taxpayers had come together for a business purpose. The Court noted that while a tax benefit may have been the prime economic force driving the investment, that tax benefit was a state law tax benefit, not a federal one—and a state law benefit clearly intended to be used in this fashion by the state in question to encourage the preservation and restoration of historic buildings.

The Court also found that the substance of the arrangement was a true contribution of capital and receipt of credit as a partner, and not a disguised sale of tax credits. The Court found that the transfer was not simultaneous and there was entrepreneurial risk—that is, there was a possibility the partnership would be unable to pool sufficient credits, as well as other risks faced by the limited partners.

SECTION: 707
TRANSFER OF ASSETS TO PARTNERSHIP FOLLOWED BY PLEDGE OF INTEREST TO RECEIVE NONRECOURSE LOAN AND RELATED PUT HELD TO BE DISGUISED SALE

Citation: United States v. G-I Holdings Inc., DC NJ, 2009 TNT 240-17, 12/14/09

The disguised sale rule of §707(a)(2)(B) was applied in a case where a taxpayer contributed assets from a division of its business worth $480 million dollars to a trust, and then shortly thereafter the interests were transferred to a trust that received a $460 million nonrecourse loan against those interests, of which $450 million was transferred to the taxpayer. A put agreement required the partnership to purchase the partnership interests of the taxpayer at the taxpayer's capital account at the time the put was exercised.

The taxpayer contended that these transactions were truly separate, and that they could not be collapsed under §707(a)(2)(B). However, the U.S. District Court of New Jersey disagreed. When it analyzed the entirety of the transaction it found that the transaction has been structured in an attempt to avoid tax on the sale of the division by creating the partnership, but then effectively disposing of that interest indirectly through the nonrecourse loan borrowing procedure.

The Court found that the taxpayer had no reasonable expectation of a profit on the underlying transaction in excess of the costs it had incurred, that its potential losses had been capped in the transaction and that the capital contribution and loan were a "package deal" that had to be looked at as whole. Thus the Court concluded that the $450 million part of the package was a disguised sale.

However the victory proved a hollow one for the IRS. The Court found that the IRS had not assessed the tax due within the three year statute of limitations period and the transaction did not cause an omission of income from the return in excess of 25% that was necessary to trigger the six year statute of limitations under §6501(e). So while the taxpayer should have paid tax on the transaction, the IRS waited too long to raise the issue.

SECTION: 736
PAYMENTS TO RETIRING PARTNER WERE ORDINARY INCOME DESPITE MISREPORTING BY PARTNERSHIP

Citation: Wallis v. Commissioner, TC Memo 2009-243, 10/27/09

A retiring partner received a set of payments from his law firm, of which $32,721 was payment for the partner's capital account and $80,000 was for "Schedule C" benefits. Schedule C referred to the partnership agreement, which provided for Class C interests for partners that had a nonownership interest and for which capital contributions were not made. The partnership agreement provided that a retiring partner would be paid for his Schedule C interests upon attaining age 68.

The partner in question owned other interests for which there were capital contributions, but had also been awarded Schedule C interests over the years. However, he reported nothing on his returns for either the payment related to his capital account or the payment for the Schedule C units. As well, his old partnership issued a Form 1099MISC reporting the $80,000 payment for Schedule C benefits as nonemployee compensation. At trial the taxpayer conceded he should have reported the proceeds, but took the position that he had sufficient basis to absorb the payment for the capital account received in that year and that the Schedule C benefit payments should be capital gain.

The Court found the payments to the partner for his capital account related to the other interests did not give rise to income, as the IRS failed to show that the payments were in excess of the partner's basis. Given that finding, there was no adjustment related to the failure to report the amount of proceeds received for the capital account.

However, the Court found the Schedule C payments were §736(a) payment, being ordinary income to the taxpayer and not capital gain. The Court also had no sympathy for the taxpayer's argument that he had failed to report the $80,000 as income because he could not do so properly (as guaranteed payments from the partnership) and also agree with the partnership's reporting (as nonemployee compensation). The Court imposed penalties on this position.

SECTION: 752
COURT FINDS ABSOLUTELY NO CHANCE OF REASONABLE PROFIT FROM SON OF BOSS TRANSACTION AND DISALLOWS TAX BENEFITS CLAIMED

Citation: Stobie Creek Investments v. United States, CA Fed. Cir. No. 2008-5190, 5/11/10

The Federal Circuit sustained the Court of Federal Appeals in its ruling that the transaction in this case lacked economic substance. The taxpayer, who had a large capital gain he was going to incur upon the sale of stock in his business, asked his attorney if he knew of some way to shelter the gain. The attorney referred his client to a law firm that was pushing a Son of BOSS style transaction. The underlying paired set of options had virtually no chance of turning a profit (in fact the Court found that it actually had no chance of turning a profit).

However, making a profit from investing in options wasn't really what the taxpayer was after. Rather the goal was, as the Court pointed out, going through a specific set of steps to get the options into a partnership, along with the stock in the company being sold to be able to use the partnership tax provisions to inflate the basis of that stock.

Under the then existing IRS regulations at the date the transaction was entered into, read literally, the partner would get basis for the purchased option contributed, but did not have to reduce that basis by the outstanding liability to close the position where the option had been sold. Once the options closed out of the money (which is realistically what was most likely to happen and did), the partnership was liquidated with the shares transferred out.

As it was a partnership distributing only a noncash asset, that asset took on the partner's (inflated) basis in his interest. In this case, the taxpayer basis in the stock shot up by $200,000,000 (or at least it did until it faced scrutiny).

The Court found there was absolutely no underlying reason to enter into the transaction other than for tax benefits, causing the Court to invoke the economic substance doctrine to disallow the tax benefits. The Court also found the taxpayer did not act reasonably to by relying on the advice of the attorneys who were involved in promoting the transactions.

The case is a reminder that even if a transaction is designed to clearly fall within the literal letter of the law and regulations, it still must pass muster against the overriding judicial doctrines that are applied to tax cases. Fundamentally, it's important to have a real, nontax reason for a transaction and the way it was structured if you plan to pass these tests.

SECTION: 752
SON-OF-BOSS TRANSACTION FOUND TO LACK ECONOMIC SUBSTANCE, SO ISSUE OF RETROACTIVE APPLICATION OF REG. §1.752-6 NOT RELEVANT.

Citation: Palm Canyon X Investments v. Commissioner, TC Memo 2009-288, 12/15/09

The Tax Court dodged the question of whether Reg. §1.752-6 can be applied retroactively to unwind a Son-of-BOSS style transaction, instead ruling that the underlying transaction lacked economic substance. The court applied both the subjective and objective prong of the economic substance test. It found that the transaction failed the subjective prong, as the nontax reasons offered for executing the transaction were not credible. Among the reasons the court ruled that way included a finding that there was no real need for the taxpayers to hedge foreign currency in the foreseeable future (one of the purported reasons for entering into the transaction), no investigation into the foreign currency aspects of the transaction, a lack of rational economic behavior in pricing the contracts, the adding of a partner solely to be able to remove that partner to trigger the basis shift in liquidation of the partnership, and that the transaction was specifically developed as a tax shelter.

The transaction also failed the objective test, which requires showing the transaction had a reasonable prospect of earning a profit. The court found that the prospects of the transaction hitting the "sweet spot" where it would turn profitable were small (estimated at 1.3% by an individual involved). And, in any event, the fees paid were greater than any potential profit the transaction might produce.

The Court also found that since it held the case was appealable to the Court of Appeals for the District of Columbia, that the transaction was subject to a penalty under §6662 for a valuation misstatement. While the Fifth and Ninth Circuits had held that the valuation negligence penalty could not apply when a transaction was disregarded for economic substance, the Tax Court disagrees with that holding. While both parties originally stated the case was appealable to the Ninth Circuit, the IRS later disagreed and the Tax Court agreed with the IRS's new view. The Court also denied relief from any other penalties under §6662.

SECTION: 754
IRS GRANTS PERMISSION TO MAKE LATE §754 ELECTION AFTER FOUR YEARS OF RETURNS FILED

Citation: PLR 201047013, 11/26/10

This ruling isn't terribly unique, but it does serve as a reminder that the IRS National Office is relatively generous in granting relief in many cases so long as the taxpayer approaches the IRS first. In the case in question a partner of a partnership died, and the accountant who was responsible for filing the §754 election admitted he had inadvertently failed to file the election to adjust basis for the estate and heirs under §743. By the time the request for relief was filed, four years of returns had been filed (including at least one amended return), all prepared reflecting adjustment to basis under §754.

The partnership requested that the IRS grant permission to make the election late under Reg. §301.9100-3, and the IRS granted that relief.

A couple of points should be noted. First, it likely was crucial to the grant of relief that the accountant admitted responsibility for failing to prepare and file the election. As well, it is important that all returns are filed reflecting the adjustments to basis, which showed that the taxpayers truly intended to make the adjustment election. Second, it is far less likely the IRS would have been so understanding had the taxpayer decided to play the "audit lottery" and hope the IRS would simply never notice the lack of the election filing.

SECTION: 1031
EXCHANGE HAD PRINCIPAL PURPOSE OF TAX AVOIDANCE, DEFERRAL OF GAIN NOT ALLOWED

Citation: Ocmulgee Fields, Inc. v. Commissioner, CA11 No. 09-13395, 8/13/10

The Eleventh Circuit Court of Appeals affirmed the Tax Court's decision that a like kind exchange between a corporation and a related partnership fell afoul of §1031(f)(4)'s denial of deferral treatment for such a related party exchange. Specifically, the appellate panel found that the Tax Court did not commit clear error in its factual finding that the transaction had as one of its principal purposes the avoidance of federal income tax.

In the transaction in question Ocmulgee Fields, a C corporation, had a highly appreciated piece of property that it was going to sell. Treaty Fields, a partnership controlled by similar interests, had a higher basis piece of property that Ocmulgee eventually identified as its replacement property. Thus, when the transactions were completed, Treaty Fields reported a taxable sale of the high basis property while Ocmulgee Fields held the property previously held by Treaty Fields, but now with a lower basis. As Ocmulgee fields would have paid a 34% corporate income tax on any taxable portion of the gain, the transaction had a secondary advantage of exposing what gain was taxable to a much lower personal income tax rate on capital gains.

The Court noted that, in addition to the obvious significant tax advantage of the deferral transaction (had it been upheld), the use of a qualified intermediary was an unnecessary complexity. The only reason it made sense to use one was because, had the transaction taken place directly between the two entities, it would have automatically been disallowed §1031 treatment by §1031(f)(1).

The Court rejected the corporation's theory that the partnership's property was merely a “fallback position” after its search for other suitable property failed, noting that only six days elapsed between the time a qualified intermediary was engaged and the contract was entered into with the partnership. The Court also found unpersuasive the taxpayer's claim of legitimate business reasons for selecting this specific property, noting that the mere existence of a legitimate business would not, in any event, establish that a principal purpose of this specific transaction remained tax avoidance.

SECTION: 2036
MERELY SHOWING DONOR HAD A RETAINED LIFE ESTATE NOT SUFFICIENT TO BRING ENTIRE VALUE OF TRANSFERRED PROPERTY INTO DONOR'S ESTATE

Citation: Estate of Stewart v. Commissioner, CA2 No. 07-5370-ag, 8/9/10

In a split decision, the Second Circuit Court of Appeals decided that although an implied agreement existed that Margot Stewart retained enjoyment of the property she had gifted, nevertheless the Tax Court erred by holding that she would retain enjoyment of the entire 49% of the property given to her son. As the Court notes, the big issue is whether, in fact, there was a truly divided interest, as the existence of such a divided interest gives rise to, in this case, a stipulated 42.5% discount for marketability.

The Tax Court had ruled that since Margot had collected all rents on the property after the gift was made and continued to pay the vast majority of expenses related to the property, she had retained an interest in the entire property, and thus the entire property came back into her estate under §2036(a)(1), by retaining the possession or enjoyment of the 49% interest.

A unique fact in this case is that the property, in addition to having a commercial tenant on the upper three floors, has a residential portion that made up the lower two floors. The decedent and her son resided in that residential portion. The majority concluded that as her son had possession of the property and, as expenses were much higher than normal, it was erroneous of the Tax Court to hold that Margot had retained the possession or enjoyment of the entire 49% interest. Thus the majority remanded the case back to the Tax Court to make a determination of exactly what portion of the interest Margot had retained, strongly implying that it would be less than the entirety of the interest transferred to her son.

The dissenting opinion objects strongly to this finding. The judge argues that absolutely nothing changed about Margot's relationship to the property following the transfer and that the majority had erroneously focused on what her son received as opposed to what Margot retained. The dissent warned that the majority's opinion turns the settled construction of §2036(a)(1) on its head, opening up a large loophole in the applicability of §2036(a)(1).

If the majority's analysis gains credence in future cases, this could dramatically change the exposure to a §2036(a)(1) attack in many cases. In recent years, demonstration of an implied life estate under §2036(a)(1) by the IRS has been the most effective tactic the IRS has had to go after fractional interest transfers during life. This holding would seem to generally require the IRS to show that the donee had not received anything of value in the transfer. However, it's important to note that this is a single case with somewhat unique facts in one circuit that gave rise to a 2-1 decision in a deeply divided panel—so it's important to understand the limits of this holding.

SECTION: 2036
TRANSFER TO PARTNERSHIP FOUND TO BE BONA FIDE SALE FOR FULL AND ADEQUATE CONSIDERATION, PARTNERSHIP ASSETS NOT REQUIRED TO BE INCLUDED IN DECEDENT'S ESTATE

Citation: Shurtz v. Commissioner, TC Memo 2010-21, 2/3/10

The Tax Court again visited the issue of whether, in forming a family limited partnership, there was a "bona fide sale for full and adequate consideration" that would serve to insulate the partnership from further analysis under §2036(a) to determine if there was a retained life estate. In this case, the decedent had transferred assets to a family limited partnership and then at her death left the remainder of her estate to a bypass trust and marital trusts, so her estate showed no amount taxable. However, if the partnership assets could be returned to the estate under §2036(a) there would be a taxable estate—and the estate would owe federal estate tax of over $4.7 million.

In this case the Court, in analyzing if there was a bona fide sale, determined there existed valid reasons apart from estate tax savings for forming the partnership. The Court found there was a legitimate concern about preserving the family business, as the alternative of having multiple undivided ownership interests impeded the management of the timberland. Even though only a portion of the assets contributed required such a level of active management, that was found to be sufficient.

The Court also found that the contributors received interests in the partnership proportionate to the ownership interest each contributed. The partnership properly accounted for each partner's interest, and it was found to be "carried out in the way that ordinary parties to a business transaction would do business with each other."

SECTION: 2036
TRANSFER TO FAMILY LIMITED PARTNERSHIP WAS BONA FIDE SALE, AND THUS VALUE OF STOCK NOT INCLUDABLE IN TRANSFEROR'S ESTATE

Citation: Estate of Black v. Commissioner, 133 TC No. 15, 12/14/09

The Tax Court ruled that a transfer to a family limited partnership of a taxpayer's interests in stock in a company he held a significant interest in, at the same time transfers by his son and two trusts for his grandchildren to the same partnership, was a bona fide sale for full and adequate consideration, and thus not subject to being yanked bank into the transferor's estate under §2036(a). The Tax Court applied the standard of the Third Circuit Court of Appeals, to which the case would be appealed, that the sale must be a good faith transfer that offers the transferor some benefit outside the transfer tax context.

The Court found that Mr. Black had a legitimate concern that shares of stock in the closely held company might be disposed of either by his grandchildren when their trusts terminated, or by his son due to feared (and eventually actual) divorce.

However, the estate of the decedent's spouse was denied a deduction for interest on a loan received from the partnership to enable her estate to pay its estate. The Tax Court that because, under the facts of the case, the only realistic way that loan could have been repaid per its terms would have been to have redeemed a portion of that estate's interest in the partnership, an action that would have served to create the same necessary liquidity had it been undertaken on the day the loan was made. The loan was deemed unnecessary, as the only effect of the loan as compared to a redemption was the creation of a deduction of $20 million for interest on the purported loan, playing off the fact that estate tax rates (which would create the benefit from the deduction) were higher than income tax rates.

SECTION: 2503
GIFTS OF PARTNERSHIP INTERESTS WERE NOT PRESENT INTERESTS

Citation: Price v. Commissioner, TC Memo 2010-2, 1/4/10

A taxpayer who made a gift of partnership interests to his children was deemed not to have made a gift of a present interest, and thus was not eligible to apply the annual gift tax exclusion to the interests transferred. In the case at hand the partnership agreement provided the following:

Members had no right to unilaterally withdraw their capital accounts

Members had no right to sell, assign or transfer their partnership interests to third parties or encumber their interests without the consent of all partners

The Court noted that since the agreement also provided that a transfer to anyone not currently a partner granted that person only an assignee interests, in fact the children were not even partners, but rather assignees under the explicit terms of the partnership agreement.

The Court also noted that although this partnership, unlike the one in Hackl, was expected to generate income, any distribution of that income was solely at the discretion of the general partner and that, in fact, in two of the prior six years there had not been distributions—thus, there was also no reasonable expectation of access to income.

The case expands on the position the Tax Court outlined in its 2002 decision in Hackl v. Commissioner, 118 TC 279, making clear that the decision there was not limited to the unique facts of the Hackl partnership's lack of income—rather, some of the very restrictions on rights that give rise to higher valuation discounts put the existence of a present interest in question.

SECTION: 2503
FRESH FROM AFFIRMATION IN CHRISTIANSEN, TAX COURT RULES USE OF FORMULA CLAUSE FOR GIFT SPLIT BETWEEN CHARITIES AND OTHERS DID NOT VIOLATE PUBLIC POLICY

Citation: Estate of Petter v. Commissioner, TC Memo 2009-280, 12/7/09

Within a month of the Eighth Circuit affirming its holding in Christiansen that formula clauses in estate planning documents do not violate public policy, the Tax Court ruled again that a formula clause in a gift split between a charity and others that served to insure that any subsequent adjustment to the value of the assets transferred would not generate a gift tax was not a violation of public policy. The Court upheld the validity of the clause, as well as a full deduction for the value of the interests eventually treated as going to the charity as of the date of the gift for income tax purposes.

The formula clause provided that, effectively, the charities would receive the portion of the donated interests in the family LLC that would be in excess of what could pass gift tax free to the other donees. When the original value was challenged on exam, the amount that would go to charity was increased, something the IRS argued frustrated public policy giving no incentive to properly value the assets.

The Tax Court disagreed, noting in this case that the charities had an obligation, if they wished to maintain their tax exempt status, not to act "in cahoots with a tax-dodging donor." As well, the state's attorney general is given the right under state law with enforcing the charity's rights—so there were checks in place to prevent abuse, so that the threat of a gift tax was not needed to insure the items were properly valued.

SECTION: 2512
TAXPAYER'S CLAIMED GIFT OF PARTIAL INTEREST AND SALE OF REMAINING INTEREST IN LLC HELD TO BE SINGLE BARGAIN SALE UNDER STEP TRANSACTION RULES

Citation: Pierre v. Commissioner, TC Memo 2010-106, 5/13/10

Suzanne Pierre had previously fared well in the first decision the Tax Court issued on her dispute with the IRS. In Pierre I (133 TC No. 2) the Tax Court ruled that the existence of an LLC was to be respected for transfer tax purposes even if, prior to the transfer, the entity had been a single member LLC taxed as a disregarded entity for income tax purposes under the "check the box" regulations.

However issues remained to be decided in the case, resulting in a second Pierre decision. Suzanne transferred securities to the LLCs, and then 12 days later managed to transfer her entire interest in the LLCs to trusts for her son and granddaughter.

The appraiser that Suzanne had hired informed her that she could transfer a 9.5% interest in each trust without triggering gift taxes, so she treated that amount as gifted and had the trusts sign installment notes to purchase the remaining interests. Income distributions from the partnership were used by the trust to pay the interest on the notes and no principal had been paid over the eight years the notes were outstanding at the time of trial.

The IRS contended that rather than a gift of an interest followed by the purchase of an interest, this was a bargain sale of a 50% interest to each trust under the step transaction doctrine. The Tax Court found Suzanne did not give any nontax reason for structuring the transaction in this fashion and held for the IRS that under the step transaction doctrine this amounted to a single transaction.

The Court also found that, since the interests should be valued as 50% interest, the minority interest discount was reduced from 10% to 8%, even though the IRS did not produce its own expert, relying on the concession from the taxpayer's expert that a 50% interest, due to the ability to block the appointment of a new manager, would receive less of a discount than a less than 50% interest.

However, the Court did not reduce the lack of marketability discount from the amount the taxpayer claimed on the gift tax return, noting that the IRS had not provided any contrary evidence. The IRS had, instead of getting a valuation prepared, relied entirely on the theory that the LLC itself could be ignored.

SECTION: 2512
CHECK THE BOX RULES DO NOT APPLY TO VALUATION OF INTEREST IN SINGLE MEMBER LLC

Citation: Pierre v. Commissioner, 133 TC No. 2, 8/24/09

A divided Tax Court held, in a reported decision, that the check the box rules for a single member LLC treated as a disregarded entity do not require that the entity be disregarded for purposes of valuing interests that are gifted by the taxpayer to other parties. Rather, marketability and minority interest discounts are properly applied to the LLC interests themselves.

Suzanne Pierre received $10 million and placed it into a single member LLC. She then created trusts for her son and granddaughter, and gave the trusts each a 9.5 percent interest and sold 40.5 of her interest to each of the trusts for a note, claiming discounts in both cases. The IRS disallowed the discounts, claiming that check the box required the entity be disregarded.

However, the majority of the Tax Court held that, based on the history of the gift tax and Supreme Court precedent, state law property rights must be used for valuation purposes, which required respecting the LLC as an entity for valuation purposes. The Court held the check the box regulations do not alter this result. Needless to say, dissenting Tax Court judges did not agree.

SECTION: 2512
GIFTING PARTNERSHIP INTERESTS BEFORE TRANSFERRING ASSETS REMOVES VALUATION DISCOUNTS FOR GIFTS

Citation: Linton v. United States, DC WD Washington, 7/1/09

Doing things in the right order can be crucial, especially in an area where the taxpayer is arguing that the formalities must be respected by the IRS in order to obtain a desired tax result. That's especially true in the area of valuation discounts for transfer tax purposes where the taxpayer is forming a family limited partnership. William Linton discovered that the cost of not getting this right can be very substantial—in his case increasing the taxable value of the gifts from approximately $1.45 million to $3.1 million.

The taxpayers left a number of documents undated as they were forming the partnerships and trusts that would hold the interests. The Court found that the Lintons could not establish that the transfers of interests in the partnership occurred after the assets were transferred to the entity. As well, the Court considered persuasive the government's contention that it was clear the entire transaction was covered by the step transaction doctrine, so that the entire transaction could be collapsed down into a gift of an interest in the property to the recipients rather than a gift of a partnership interest.

SECTION: 2518
EIGHTH CIRCUIT RULES A FRACTIONAL DISCLAIMER DOES NOT VIOLATE PUBLIC POLICY

Citation: Estate of Christiansen, CA8, No. 08-3844, 11/13/09

The Eighth Circuit held in the Estate of Christiansen that a fractional disclaimer of an inheritance above a set amount did not violate public policy, and allowed the recalculation of the amount of the disclaimer, also holding that the IRS examination was not an "act or precedent event" that would trigger Reg. §20.2055-2(b)(1). On the public policy issue, the Eighth Circuit held that merely because such a fractional disclaimer would create a situation where the IRS would not be able to collect any additional tax if it challenged the value of the asset, that did not violate any public policy.

The Court noted that the IRS was charged with enforcing the tax laws, and not with collecting the maximum amount of tax. The Court found no indication that Congress had, as a matter of policy, wanted to give the IRS the incentive to collect the maximum tax and thus a fractional disclaimer that would have the effect of eliminating any possible tax did not violate any public policy. The Court also pointed out that, in this particular case, due to other issues that 25% of the increase in value would create a tax liability.

The Eighth Circuit's willingness to address and reject the public policy argument is a matter of interest, since such fractional formulas that serve to insure that any change in value simply increases the transfer to a entity for which a full deduction would be allowed is a technique that is sometimes used in estate planning documents.

SECTION: 6015
TAX COURT HAS NO RELIEF TO OFFER INNOCENT SPOUSE PRIOR TO RESOLUTION OF PARTNERSHIP'S TEFRA CASE

Citation: Adkison v. Commissioner, CA9 No. 08-70485, 1/21/10

Peter Adkison and his former spouse were partners in a partnership that came under IRS scrutiny in TEFRA proceedings. The IRS issued a Notice of Final Partnership Administrative Adjustment to the partnership at the conclusion of its examination and the partnership timely filed a petition for readjustment of partnership items under TEFRA.

Shortly after that petition was filed, Peter filed a request for innocent spouse relief due to his participation in the shelter. The IRS did not respond to this request but issued a Notice of Deficiency, despite the fact that the TEFRA proceeding was (and is) still pending. Peter filed a petition with the Tax Court invoking §6015(e) innocent spouse relief.

The Tax Court determined that it did not have jurisdiction to hear the case and dismissed it. The Ninth Circuit Court of Appeals agreed with the result, but not the reasoning of the Tax Court. It noted that the statutory arrangement did not contemplate the IRS issuing a Notice of Deficiency while a TEFRA proceeding was ongoing. However, it held that since a notice had been issued and relief requested, the Tax Court's jurisdiction under §6015(e) was triggered.

However due to the TEFRA proceeding that was ongoing, there was no appropriate relief available under §6015(e) that the Tax Court could grant, as the Notice of Deficiency itself was barred. If the TEFRA proceeding result in a deficiency, only then would Peter be able to file a petition for determination of the allocation of the deficiency between the spouses under §6015.

The Ninth Circuit also wondered in a footnote whether or not the IRS couldn't have simply mooted the Tax Court petition had it simply withdrawn the Notice of Deficiency, a notice it claims it sent solely to "protect itself" because it wasn't sure how the TEFRA proceedings would play out.

SECTION: 6226
FEDERAL CIRCUIT AGREES WITH D.C. CIRCUIT THAT PARTNERS BASIS IN SHELTER TRANSACTION IS AN AFFECTED ITEM, NOT A PARTNERSHIP ITEM

Citation: Jade Trading, LLC v. United States, CAFC, No. 08-5045, 3/23/10

The Federal Circuit Court of Appeals concluded that the Court of Federal Claims properly found the offsetting option transaction executed by the partners to attempt to execute a variant of a basis enhancing partnership transaction was a sham lacking economic substance.

However, agreeing with the D.C. Circuit analysis in the earlier Petaluma Partners FX case, the Court held that the question of the partners' basis in the partnership was an affected item and not a partnership item. As such, the Court of Federal Claims lacked jurisdiction to have sustained the IRS's assessment of penalties at the partnership level based on the basis inflation, but rather the matter was one that had to be decided at the partner level.

Effectively this case is a virtual duplicate of the Petaluma case—both courts sustained the trial courts' holding that the partnership transaction itself lacked economic substance, but both courts also ruled that the basis impact creates a penalty issue that has to be decided at the individual partner and not partnership level and overturned the trial court's treating that issue as a partnership item under the TEFRA partnership procedures.

SECTION: 6226
TAX COURT HAD JURISDICTION TO DETERMINE PARTNERSHIP A SHAM, BUT NOT TO DETERMINE AFFECT ON INDIVIDUAL PARTNERS' BASIS

Citation: Petaluma FX Partners, LLC v. Commissioner, CA DC, Docket No. 08-1356, 2010 TNT 8-9, 1/12/10

The Court of Appeals for the District of Columbia affirmed in part and reversed in part the Tax Court's earlier holding in Petaluma FX Partners, LLC v. Commissioner (131 TC No. 9).

The Court of Appeals agreed that the Tax Court had jurisdiction to determine the entity was a sham and that the determination was a partnership item within the meaning of §6226(f). The Court found that the determination clearly related to the proper amount to reported from the partnership for income tax purposes, and that the most appropriate level to determine whether the partnership is a sham is at the partnership level.

However, the Court of Appeals held that the Tax Court did not have jurisdiction in this case to make the determination that the partners had no basis in their interests. The Court did not rule the Tax Court was in error on the point—just that it had no right to make that ruling at that point. The opinion notes that "the fact that a determination appears obvious or easy does not expand the Court's jurisdiction beyond what the statute provides." Similarly, the Tax Court lacked jurisdiction to determine that, due to this lack of basis, accuracy related penalties applied to the partners.

SECTION: 6229
FEES PAID RELATED TO SON OF BOSS PARTNERSHIP TRANSACTION TRANSACTION BILLED TO S CORPORATION NEVERTHELESS IS AN AFFECTED ITEM

Citation: Domulewicz v. Commissioner, TC Memo 2010-177, 8/5/10

If over $1,000,000 of fees related to a partnership transaction are billed to an S corporation that the same taxpayers controlled, are those fees properly treated as an affected item? The question was crucial because only if they were was the statute of limitations still open for the IRS to assess tax related to a disallowance of the expenses.

The Tax Court held that the provisions of §6229 operated in this case to keep the statute open, as the fees were an affected item. The Tax Court noted that the fees were related to the Son of BOSS transaction itself, a factor that was not clear from the original returns in question. As the partnership itself was held to be a sham, the issue of the deductibility of these fees were an affected item, since the transactions required a determination at the partner level and the fees' deductibility related to the partnership transaction.

The taxpayer's claim that because the fees had been billed and paid through their S corporation rendered them not affected items was rejected by the court.

SECTION: 6231
ITEMS AFFECTING NONPARTNERS NOT AFFECTED ITEMS NOR PROPERLY HANDLED VIA TEFRA PROCEDURES

Citation: Chief Counsel Email 201042036, 10/22/10

Just because an item arises in a TEFRA partnership examination, it does not follow that TEFRA governs treatment of all taxpayers involved in the transaction. A Chief Counsel's office email noted that a recharacterization on a partnership exam of a loan by a corporation to a partnership was not an affected item to the corporation, as the corporation was not a partner, and its treatment is not bound by the treatment found on exam at the partnership level.

Similarly, an issue that arose where Mom may have made a deemed gift to the partners in a family partnership was also not properly assessed via a TEFRA proceeding as, in the case in question, Mom was not a partner of the partnership.

SECTION: 6231
DESIGNATION OF A TAX MATTERS PARTNERS ON A 1065 BY PARTNERSHIP OTHERWISE EXEMPT FROM UNIFIED TEFRA PROCEDURES DOES NOT SERVE AS ELECTION TO HAVE PROCEDURES APPLY

Citation: Chief Counsel Email 201018010, 5/7/10

The naming of a Tax Matters Partner on the return of a partnership that otherwise is exempt from the TEFRA partnership examination procedures does not serve as an election under §6231(a)(1)(B)(ii) to have the unified procedures of §6231 apply, the IRS Chief Counsel's office noted in an email. The email pointed out that while the designation of a Tax Matters Partner is only required for TEFRA partnerships, many partnerships routinely fill in that portion of the Form 1065—but that does not serve to make the election to have the unified audit procedures apply.

To make an effective election, the partnership would need to follow the guidance found in Reg. §301.6231(a)(1)-1(b)(2) which must be signed by all persons who were partners at any time during the partnership year and shall be filed at the time and place designated for filing the partnership return.

SECTION: 6231
IRS REQUIRED TO ISSUE NOTICE OF DEFICIENCY IF NO PARTNERSHIP ITEM IS CHANGED, BUT ERROR WAS HARMLESS

Citation: Bush v. United States, CA FC, No. 2009-5008, 3/31/10

The Federal Circuit reversed part of the holding of the Court of Federal Claims in deciding that a notice of deficiency was required when a closing agreement in a TEFRA partnership case stated that no partnership item would be adjusted, but rather each partner's amount at risk would be capped at $50,000. The Federal Circuit held that it was not sufficient that the individual partner's liability could be fully computed from the closing agreement with no other information—§6231(a)(6) specifically limits a computation adjustment, for which no deficiency notice is required, to changes that reflect the proper treatment of a partnership item.

However, the Federal Circuit ruled that this defect in the end wouldn't help the taxpayers in their refund case. The taxpayers had argued that because no notice of deficiency was issued, they were denied their right to litigate the case in the Tax Court. However, the Federal Circuit found that because the taxpayers had paid the tax voluntarily before any collection proceedings were initiated by the IRS, they could not now get the refund solely on the fact that the IRS hadn't issued the notice.

Had the IRS actually initiated collection proceedings, the result would be different—but since no collection proceedings took place, the taxpayers were required to show they were prejudiced by litigating the case in a refund proceeding rather than in the Tax Court. Thus, the Federal Circuit held, the failure to issue the deficiency notice was "harmless error" in this matter. The Court makes clear that "what the taxpayer may not do is forgo his right to resist collection, voluntarily pay the tax, and then secure a refund of tax admittedly owed without showing prejudice."

SECTION: 6331
PARTNERS DRAWS ARE SUBJECT TO IRS LEVY ON WAGES

Citation: United States v. Moskowitz, Passman & Edelman, CA2 No. 08-3017-cv, 4/29/10

The managing partner of a law firm had a significant amount of unpaid taxes outstanding. To collect those taxes, the IRS issued a levy to the law firm on the taxpayer's salary pursuant to §6331(e). The managing partner ignored the levy, contending the weekly checks he wrote himself were draws on his rights to firm profits, as determined at year end, and not salary—after all, he was a partner and we all know that the IRS position is that a partner in a partnership cannot be paid a salary for tax purposes.

But the Second Circuit held that our question here is not what the definition of "salary" is under state law, or any context other than its definition for purposes of §6331(e) which provides for a continuous levy on wages and salaries. The Court of Appeals notes that a partner, under the applicable state law, has a property interest in the profits of the partnership as determined by the partnership agreement. The Court also noted that under the regulations interpreting §6331(e) the IRS held that salaries and wages included amounts paid or advanced to a taxpayer as compensation for services.

The managing partner provided services to the partnership, for which he received a portion of the partnership profits—in the Court's view a payment for services. The weekly draws he took were an advance on such rights to profits, and advances were specifically addressed in the regulation. The Court found the regulation's definition of what constitutes "salaries and wages" to be reasonable, and therefore held that the law firm was liable to the IRS for the amounts it failed to turn over on the levy against amounts to be paid to the managing partner.

SECTION: 6404
INTEREST ABATEMENT PROPERLY DENIED WHEN TMP FOR PARTNERSHIP CEASED COOPERATING, EVEN THOUGH BINDING AGREEMENT EXISTED ON RESOLVING CASE

Citation: Swanson v. Commissioner, TC Memo 2010-131, 6/15/10

The taxpayer in this case protested that the IRS should have abated interest on the assessment against tax due from changes made to a partnership they had invested in. The partnership they had invested in filed a stipulation that the partners would be bound by the results in a similar case, a case that was decided in the IRS's favor and became final on April 8, 1998. However, the taxpayers did not receive a notice of deficiency until May of 2006.

But the Court noted that the partnership's tax matters partner refused to cooperate after the controlling case was decided, eventually refusing to perform any duties. In August of 1999 the IRS informed the partners that they were going to deny all deductions, that the tax matters partner had abdicated his role and to contact the IRS representative handling the matter.

Apparently none of the partners took any action, and the matter remained in limbo until February of 2005 when the Tax Court received updated addresses on the partners and sent out a notice asking them to show cause why the IRS adjustments should not be allowed. No partners showed such cause, so a final order was entered in April 2005.

The Court found that the IRS was not responsible for the delay from April 1999 to April 2005, a period during which it seems the partnership representatives stopped cooperating. The IRS needed an entry of a final order in order to begin preparing the TEFRA closing packages for the partners—and the Court did not find that the time from April 2005 until the May 2006 issuance of the deficiency notice was unreasonable.

SECTION: 6501
IRS REGULATIONS APPLYING SIX YEAR STATUTE TO LARGE OVERSTATEMENT OF BASIS HELD INVALID BY TAX COURT

Citation: Intermountain Insurance Service of Vail, LLC v. Commissioner, 134 TC No. 11, 5/6/10

The majority of the Tax Court went out of its way to strike down an IRS Temporary Regulation when the IRS asked to grant a motion to vacate the Court's original decision and rule on the matter under temporary regulations issued after the original decision. The question involved whether a taxpayer's overstatement of basis by a taxpayer created a omission from gross income that, if large enough, triggers the six year statute of limitations under §6229(c)(2).

Previously the Tax Court, citing its prior decision in Bakersfield Energy Partners, LP, 128 TC 207, affirmed on appeal by the Ninth Circuit, held that a basis overstatement did not amount to an omission from income and therefore ruled for the taxpayer in this case that IRS was time barred from assessing the tax. Less than a month after that decision, the IRS published Temporary Regulations §§ 301.6229(c)(2)-1T and 301.6501(e)-1T that held that an overstatement of basis is an omission from income, with an effective date for any taxable years for which the period for assessing tax had not expired by the date the regulations were published. In the IRS's view, since the regulations, if applied, would have meant the statute was open, the Tax Court no longer could rule assessment of the tax was time barred.

The majority of the Tax Court first ruled that the language of the regulation itself made the regulation inapplicable—the statute was closed already when the regulation was issued, and under its terms the issuance of the regulation itself could not extend the statute under the plain meaning of the effective date the IRS itself had placed on the regulation. That, in of itself, would have been enough to end the case.

But the Tax Court continued on to rule that the Temporary Regulations are in violation of the clear language of the statute, as interpreted by the 1958 U.S. Supreme Court in the Colony, Inc. case. Since, in the Tax Court's view, the Supreme Court had ruled the plain meaning of the statute required that some item of gross income be omitted from the return, the IRS could not by regulation overturn the law. Thus, the case holds that the IRS's temporary regulation is invalid, so the IRS would fail even if they had not fouled up the effective date.

There were a number of concurring opinions that, while agreeing with the result in this case (the IRS does not deserve to have the matter reopened), disagreed with how the majority arrived at that decision, complaining that the majority had written an unnecessarily broad decision when other, case specific grounds, would have sufficed to arrive at the result.

However, at this point the IRS faces a reported Tax Court decision holding that the temporary regulations issued in September of 2009 are invalid, and that the holding of the Bakersfield case continues to apply.

SECTION: 6501
IRS, AFTER LOSING IN COURT, REVISES REGULATIONS TO REDEFINE AN OVERSTATEMENT OF BASIS AS CREATING AN UNDERSTATEMENT OF INCOME UNDER §6501(E)(1)(A)

Citation: TD 9466, Temp. Reg. §301.6501(e)-1T, 9/28/09

Smarting from losses in the case of Bakersfield Energy Partners (568 F.3d 767, CA9) and Salman Ranch Ltd. (573 F.3d 1362, CA FC), the IRS has issued temporary regulations holding that an overstatement of basis for assets sold will count in determining if there has been an understatement of gross income for purposes of applying the 25% omission of income test under IRC §6501 that triggers a six year statute of limitations on assessment. In both of the above cases the courts ruled that the item of gross income to be tested was the sales price reported and not the net gain/loss reported when looking to trigger the six year statute. Both courts determined that Congress's key issue was insuring the IRS was put on notice about the transaction, which reporting the sale did.

However the IRS is not happy with that decision, being aware that quite often the item is reported as a single line item on a K-1 from a passthrough entity. The IRS indicates that under the "adequate disclosure" exception a taxpayer who adequately discloses the nature and amount of the omissions from gross income will not be subject to the six year statute.

The IRS is attempting an end run around the contrary decisions by changing the temporary regulations to clearly state that overstatements of basis amount to an understatement of income, noting that both courts had commented that the previous temporary regulations were ambiguous. The IRS position is that these new regulations apply to all cases where the period of time for assessing tax had not expired by the time the regulations were issued.

SECTION: 6662
CORPORATION'S RELIANCE ON OPINION LETTER FROM CPA FIRM INVOLVED IN STRUCTURING TRANSACTION NOT REASONABLE, PENALTIES APPLIED

Citation: Canal Corporation v. Commissioner, 135 TC No. 9, 8/5/10

A corporation's reliance on an opinion letter from its CPA firm regarding a transaction that the CPA firm member authoring the letter had been involved in designing was not reasonable. Since the opinion itself used unreasonable assumptions and failed to show substantial authority existed for the opinion, the taxpayer was held liable for the substantial understatement penalty for the tax related to the disallowance of the transaction.

The CPA firm in question was the auditor for the corporation and had been such for many years. However the transaction in question, which was meant to allow the client to dispose of a subsidiary, was structured with the help of a member of the firm other than the company's long time engagement partner, and that member later issued an opinion letter that indicated the transaction "should" receive a favorable tax treatment, the highest level of comfort this firm would give for such a letter.

In fact, the firm's fee for the letter, $800,000, would only be paid if the underlying transaction closed, and the transaction would not close unless a "should" letter could be obtained to support the hoped for tax treatment. The taxpayer had agreed to a significantly lower sales price than it otherwise would have been willing to accept only because of its belief this transaction would not subject it to a large income tax payment.

The Tax Court first found that the underlying opinion did not rise to the standard required to show substantial authority existed for the opinion. It found that the opinion used unreasonable assumptions, and that the drafting member of the firm had created bright line tests that did not exist under the law by using rulings on matters totally unrelated to the issues at question. In fact, the court found no authority existed for the matters being discussed, rather the crucial issues addressed relied solely on what the court found to be the "dubious" legal reasoning of the author.

The Court indicated that given the lack of any authority on the matter at hand, it seemed unreasonable to believe a “should” opinion would have been issued by the firm if they had not been involved in the transaction. The underlying conflict of interest in this matter, which the taxpayer clearly should have taken into account, rendered the taxpayer’s reliance on this opinion unreasonable. While a taxpayer can reasonably rely even on the erroneous opinion of a truly independent competent tax adviser, the same will not be true where it is clear the adviser had a vested interest in arriving at a particular conclusion. In this case, regardless of the work the firm did on the opinion, it would be paid exactly $800,000 if and only if it issued the requested “should” opinion.

SECTION: 6662
ACCURACY RELATED PENALTY AND EXCESSIVE CLAIM FOR REFUND PENALTIES WILL APPLY TO AMOUNTS ATTRIBUTABLE TO TRANSACTIONS LACKING ECONOMIC SUBSTANCE

Citation: Patient Protection and Affordable Care Act, IRC Sections 6662(b)(6) and 6676(c), 3/30/10

Effective for transactions entered into after March 30, 2010, the 20% accuracy-related penalty on underpayments will apply to any disallowance of a tax benefit for a transaction lacking economic substance pursuant to the newly enacted §7701(o) or failing to meet the requirements of any similar rule of law [§6662(b)(6)].

Similarly, and with the same effective date, the 20% penalty for an excessive claim for refund will apply to any claim for refund that is attributable to the above types of transactions [§6676(c)].

SECTION: 6662
IRS OUTLINES ADEQUATE DISCLOSURE FOR PURPOSES OF §6662 AND §6694

Citation: Revenue Procedure 2010-15, 1/27/10

After not issuing its normally annual revenue procedure regarding disclosures on tax returns in 2009, the IRS returned to issuing the annual document in 2010, applicable for 2009 income tax returns. The document outlines disclosures made on the return that will be deemed to be adequate to escape the penalty for substantial understatement of tax without having to file a Form 8275 or 8275-R for positions that have, at a minimum, a reasonable basis. The requirements are listed generally by form and information type, and describe what items will and will not constitute adequate disclosure.

This year’s version of the revenue procedure added description of new schedules required to be filed by Forms 1120 and 1065 filers filing Schedule M-3.

The document outlines what the IRS expects of taxpayers when filling out tax returns forms to properly disclose items and should be reviewed by all individuals who are involved in the preparation of tax returns.

SECTION: 6698 & 6699
PENALTIES INCREASED DRAMATICALLY FOR LATE FILED PARTNERSHIP OR S CORPORATION RETURNS

Citation: Worker, Homeowner, and Business Assistance Act of 2009, Sec. 16, 11/6/09

Congress has revisited what has become a recent favorite place to visit to find funds—raising the penalties imposed on late filed partnership and S corporation returns. The penalties for late filed returns for taxable years beginning after December 31, 2009 will be $195 per partner/shareholder per month or portion of a month. The penalty continues for up to 12 months. This is an increase from the current level of $89 per month.

SECTION: 7422
CHARACTERIZATION OF TRANSACTION AS SHAM A PARTNERSHIP ITEM, STATUTE OF LIMITATIONS DEFENSE NOT AVAILABLE TO THE INDIVIDUAL PARTNERS IN REFUND ACTION

Citation: Prati v. United States, Deegan v. United States, CA FC, Nos 2008-5117, 2008-5129, 5/5/10

Taxpayers are generally barred from challenging the treatment of partnership items when they are resolved in a proceeding subject to the TEFRA rules for certain partnerships. So, not surprisingly, the question of what is a partnership item is a matter of dispute. In this case, the taxpayers were challenging whether they could litigate a statute of limitations issue, as well as whether they could challenge the finding that a partnership transaction was a sham.

The taxpayers asserted, based on the Federal Circuit's prior holding in AD Global Fund, LLC, that the statute had expired on the IRS's ability to assess tax against the taxpayers under §6501. Since the court had held that §6229 "does not create an independent statute of limitations," the taxpayers argued that only the standard §6501 statute period applied to them unless, apparently, the IRS specifically were able to get the taxpayers to agree to the application of §6229. The Federal Circuit disagreed with the taxpayers' reading of the Court's prior decision—the panel explained that §§6229 and 6501 operate in tandem to create a single limitations period, and a taxpayer cannot assert one in isolation to avoid liability.

The taxpayers also argued that they should be able to challenge the court's finding that the transaction was a sham, which for the year in question involved a higher level of interest on the underpayment under former §6621(c). However, the Court held that the characterization of a partnership's transaction is a partnership item.

While we no longer contend with §6621(c) specifically, the newly enacted §6662(b)(6) 20% accuracy-related penalty on underpayments from transactions found to lack economic substance under new §7701(o) would seem likely to be treated similarly.

SECTION: 7422
IRS SETTLEMENT DID NOT AMOUNT TO CONCESSION ON SHAM TRANSACTION DOCTRINE OR THAT SHAM TRANSACTION ISSUE NOT A PARTNERSHIP ITEM

Citation: Schell v. United States, CA FC 2009-5010, 12/22/09

The taxpayers argued that the fact that the IRS had entered into an agreement with the taxpayers settling the question of the proper deductions from a partnership on their individual returns amounted to either a) a concession by the IRS that the transactions were not shams nor b) convert the question of whether the transactions were sham transactions into something other than a partnership item with regard to the taxpayers. The IRS examined two partnerships in which the taxpayers had invested, issuing Final Partnership Administrative Adjustments denying all losses. The partnership contested the IRS position.

After the FPAA was issued but before the case was decided by the Tax Court, the taxpayers entered into an agreement with the IRS regarding their claimed deduction from the partnerships where the IRS and taxpayer agreed to reduce the claimed deductions by between fifty and fifty-five percent.

The IRS continued against the partnership itself, and ultimately the Tax Court concluded that the items the IRS questioned lacked economic substance and denied the deductions in full.

The taxpayers claimed that the IRS's settlement with them was effectively a concession that the transactions were not shams. However, the Court of Appeals for the Federal Circuit did not agree, holding instead that the settlement did not address whether or not the transactions were shams and the fact that some deduction was allowed simply was part of the settlement. As well, the Court also ruled that the independent agreement did not convert the question of whether the transactions were not shams into something other than a partnership item. Thus, the Court of Appeals for the Federal Circuit ruled, the Court of Federal Claims properly ruled it had no jurisdiction.

SECTION: 7701
LATE REQUEST FOR AUTOMATIC RELIEF UNDER REV. PROC. 2009-41 SHOULD RESULT IN CHANGE EFFECTIVE EXACTLY 3 YEARS AND 75 DAYS PRIOR TO DATE OF REQUEST

Citation: Chief Counsel Email 201036019, 9/10/10

In emailed advice the Chief Counsel's office considered an issue arising under Revenue Procedure 2009-41, the ruling that liberalized the relief for late entity choice elections under the check the box regulations, giving automatic relief in some cases. The question discussed in this letter is what should the IRS Service Center do if a taxpayer files for such relief, but the request is filed more than 3 years and 75 days after the requested effective date.

Revenue Procedure 2009-41 requires that the taxpayer must request relief within 3 years and 75 days after the date when the election had originally been intended to be effective and show reasonable cause for the late filing.

Interestingly enough, the email suggests the proper course is for the IRS to initially grant the request effect as of the date 3 years and 75 days before the filing date of the request. That is interesting because, in fact, the taxpayer is not claiming an intent to have made that arbitrary date as the date for which a change of entity was to be effective.

The email notes that the Service Center should suggest to the taxpayer that it could apply for a private letter ruling granting relief back to the originally requested date. Note that such a ruling would have to go through the formal ruling request procedure including the payment of the required fee.

SECTION: 7701
ECONOMIC SUBSTANCE DOCTRINE CODIFIED

Citation: Patient Protection and Affordable Care Act, Added 7701(o), 3/30/10

Effective for transaction entered into after March 30, 2010, a statutory economic substance doctrine provision will apply [§7701(o)].

For transactions to which the economic substance doctrine applies, a transaction will be deemed to have economic substance only if it satisfies two criteria. First, the transaction must change in a meaningful way, apart from Federal income tax effects, the taxpayer's economic position. Second, the taxpayer must have a substantial purpose, aside from Federal income tax effects, for entering into the transaction [§7701(o)(1)]. A State or local income tax effect which is related to a Federal income tax effect is treated as a Federal income tax effect [§7701(o)(3)]. For individuals this statutory test applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income—effectively removing personal transactions for which the IRC allows a tax benefit from this provision [§7701(o)(5)(B)].

If a taxpayer claims to rely on the profit potential of a transaction to demonstrate economic substance, special rules apply. A profit potential is demonstrated only if the present value of reasonably expected pre-tax profits is substantial in relation to the present value of the expected tax benefits that would be allowed if the transaction were respected [§7701(o)(2)(A)]. Regulations are to be issued regarding the proper treatment of foreign taxes as expenses in determining pre-tax profits in appropriate cases [§7701(o)(2)(B)].

Financial accounting benefits that originate from the reduction of Federal income taxes are not to be considered in the determination of whether the taxpayer had a substantial purpose aside from Federal income taxes for entering into the transaction [§7701(o)(4)].

The economic substance doctrine is defined as the common law doctrine under which tax benefits under Subtitle A of the IRC (the income tax subtitle) with respect to a transaction are not allowable if a transaction does not have economic substance or lacks a business purpose [§7701(o)(5)(A)]. This provision does not impact the determination of whether the doctrine is applicable to a transaction [§7701(o)(5)(C)]. Any reference to a transaction in this provision also includes a series of transactions [§7701(o)(5)(D)].

SECTION: 7701
IRS LIBERALIZES RELIEF FOR LATE ENTITY ELECTIONS UNDER CHECK THE BOX RULES

Citation: Revenue Procedure 2009-41, 9/3/09

The IRS liberalized the rules for automatic late election relief for entity classification elections. For an entity that failed to timely file an election to make or change its entity classification, it can qualify for automatic relief if all returns have filed consistent with the classification chosen (if any returns have yet been due), the only reason the entity does not have its intended classification is due to the late filing of Form 8832, the entity has reasonable cause for the late filing and the request is filed within 3 years and 75 days of the date the entity intended to have its different classification.

An election under this procedure must be filed on a Form 8832 that includes a declaration that all requirements of the procedure have been met and, until Form 8832 is modified, must have “Filed Pursuant to Rev. Proc. 2009-39” written at the top of the Form 8832. The 8832, the declaration and the reasonable cause statement must be filed with the applicable IRS service center.