

# **INTRODUCTION TO TAXATION**

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**INTRODUCTION TO  
TAXATION**

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## Chapter 1

### TAX BASE, TAX RATES, AND TAXABLE UNITS

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

#### § 1.01 Tax Base

##### [B] Types of Deductions

##### Pages 5-6, add the following

1. The election to take an itemized deduction for state and local general sales taxes instead of income taxes (in § 164(b)(5)) has been extended through 2012.
2. The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) allowed a taxpayer to deduct sales and excises taxes on the purchase of certain new motor vehicles on or before December 31, 2009. § 63(c)(1)(E). The deduction was phased out as modified adjusted gross income (MAGI) exceeded a certain threshold amount. This provision is no longer in the law and is noted here as one of many examples of using the tax law to stimulate selected economic activity.

##### [D] Inflation Adjustments

##### Page 6

The following are the inflation-adjusted figures for tax year 2011.

##### Standard deduction:

Single individual	\$ 5,800
Married couple, filing jointly	11,600
Head of household	8,500

**Personal exemption deduction:** \$ 3,700

#### § 1.02 Tax Rates

##### [A] Progressivity; Marginal Tax Rates

##### Page 7

The following are the inflation-adjusted figures for tax year 2011.

<u>Taxable income</u>	<u>Tax rates</u>	
<u>Married-file jointly</u>	<u>Single</u>	
> 379,150	> 379,150	35%
> 212,300 to 379,150	> 174,400 to 379,150	33%
> 139,350 to 212,300	> 83,600 to 174,400	28%
> 69,000 to 139,350	> 34,500 to 83,600	25%
> 17,000 to 69,000	> 8,500 to 34,500	15%
Not over \$17,000	Not over 8,500	10%

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

Relief from the marriage tax penalty for income subject to the 15% tax rate has been provided by making the top of the 15% bracket for a married couple twice the top of the 15% bracket for a single taxpayer (69,000 = 2 times 34,500). Absent this provision, the inflation-adjusted top of the 15% bracket for a married couple would be less than twice the top of the 15% bracket for a single taxpayer.

**Pages 8-11, delete [C] “Phantom” Marginal Tax Rates**

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

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

**Replace [C] with the following**

**[C] Medicare Tax on “Unearned” Income**

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

The tax is 3.8% of the lesser of (1) net investment income or (2) modified adjusted gross income in excess of \$200,000 for an individual and \$250,000 for a married couple. These threshold amounts reflect President Obama’s pledge not to raise taxes on individuals with lesser amounts of income. For example, assume an individual has \$180,000 of wages, \$45,000 of unearned income, and modified adjusted gross income of \$215,000. The 3.8% tax would be imposed on \$15,000 (the lesser of \$215,000 minus \$200,000; and \$45,000).

**§ 1.03 Deduction for Dependents**

**[A] Dependent Children and the Taxable Unit**

**Page 11, add the following**

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

#### **§ 1.04 Married Units**

##### **Page 20, add the following**

*Statute of limitation; Statutory interpretation.* **§ 6015(f)** gave rise to an interesting statutory interpretation issue in *Lantz v. Commissioner*, [607 F.3d 479](#) (7th Cir. 2010), reversing, [132 T.C. 131 No. 8](#) (2009). The statute—in **§ 6015(b) & (c)**—explicitly required filing for innocent spouse relief within two years of the IRS' first collection action, but **§ 6015(f)** was silent on a filing date. Nonetheless, a Treasury regulation implementing **§ 6015(f)** stated that the taxpayer had to file for innocent spouse relief within two years. The Tax Court refused to follow the Regulation because of the contrast between the explicit statutory limitation periods in **§ 6015(b) & (c)** and silence in **§ 6015(f)**. On appeal, Judge Posner held for the government.

[We do] not accept “audible silence” as a reliable guide to congressional meaning. “Audible silence,” like Milton’s “darkness visible” or the Zen *koan* “the sound of one hand clapping,” requires rather than guides interpretation. Lantz’s brief translates “audible silence” as “plain language,” and adds (mysticism must be catching) that “Congress intended the plain language of the language used in the statute.” . . .

Agencies, [] being legislative as well as adjudicatory bodies, are not bashful about making up their own deadlines. And because they are not bashful, and because it is as likely that Congress knows this as that it knows that courts like to borrow a statute of limitations when Congress doesn’t specify one, the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision. Whether the Treasury borrowed the two-year limitations period from subsections (b) and (c) or simply decided that two years was the right deadline is thus of no consequence; either way it was doing nothing unusual.

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

#### **§ 1.05 Earned Income Credit**

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

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

The inflation-adjusted amounts for the earned income credit for tax year 2011 are as follows. The figures include an upward adjustment to the phase-out threshold for married couples adopted by the American Recovery and Reinvestment Act of 2009 (the Obama stimulus law).

Earned income base amount:

No children	\$ 6,070
One child	9,100
More than one child	12,780

Phase-out thresholds:	
Married, filing jointly:	
No children	\$ 12,670
One or more children	21,770
Other taxpayers:	
No children	\$ 7,590
One or more children	16,690

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

For 2011 the inflation-adjusted amount of disqualified income above which the EIC is denied equals **\$3,150**.

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

**Page 22, add the following (dealing with the “phantom tax rate”)**

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

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

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

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

## **§ 1.06 Child Tax Credit**

**Pages 22-23, add the following**

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

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

## **§ 1.09 Recovery Rebate Credits**

**Page 25, delete this section**

## Chapter 2

### WHOSE INCOME IS IT?

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#### § 2.04 Domestic Partners

##### Page 32, add the following

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

In 2005, California law significantly expanded the rights and obligations of persons entering into a California domestic partnership for state property law purposes, but not for state income tax purposes. Specifically, the California Domestic Partner Rights and Responsibilities Act of 2003 (the California Act), effective on January 1, 2005, provided that “Registered domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law . . . as are granted to and imposed upon spouses.” However, the California Act provided that “earned income may not be treated as community property for state income tax purposes.”

On September 29, 2006, California enacted Senate Bill 1827. Senate Bill 1827 repealed the language of the California Act providing that earned income was not to be treated as community property for state income tax purposes. Thus, effective January 1, 2007, the earned income of a registered domestic partner (RDP) must be treated as community property for state income tax purposes (unless the RDPs execute an agreement opting out of community property treatment). As a result of the legislation, California, as of January 1, 2007, treats the earned income of registered domestic partners as community property for both property law purposes and state income tax purposes.

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

California community property law developed in the context of marriage and originally applied only to the property rights and obligations of spouses. The law operated to give each spouse an equal interest in each community asset, regardless of which spouse is the holder of record.

By 2007, California had extended *full community property treatment* to registered domestic partners. Applying the principle that federal law respects state law property characterizations, the federal tax treatment of community property should apply to California registered domestic partners. Consequently, for tax years beginning after December 31, 2006, a California registered domestic partner must report one-half of the community income, whether received in the form of compensation for personal services or income from property, on his or her federal income tax return.

## Chapter 3

### DEFINING INCOME

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#### § 3.04 Capital Gains Preference

##### [B] History of Preferential Treatment

###### Page 47, add the following

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

#### § 3.06 What is Income—Accession to Wealth

##### [A] From “Sources” to “Accession to Wealth”

##### [2] Note on Statutory Interpretation

##### [d] General Welfare Exclusion

###### Page 59, add the following

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

##### [3] Dominion and Control

###### Page 60, add the following

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

The City has an easement or other property interest over driveway approaches, which include the sidewalks, curbs, and gutters within driveways. Accordingly, the City shares with property owners the responsibility of maintaining driveway approaches. As a rehabilitation incentive, the City implemented the Program to reimburse the costs of replacing existing driveway approaches, including sidewalks, curbs, and gutters within driveways, that are deteriorated, broken, and/or hazardous, as determined by the Department. . . .

Under the Program, the City generally reimburses property owners a maximum of 50 percent of rehabilitation cost. In order to receive the reimbursement, applicants must (i) own properties that are located within the City and (ii) comply with the Program procedure . . . . In certain cases, the City reimburses 100 percent of the rehabilitation cost. Full reimbursement is made if applicants (i) meet the requirements for the 50 percent reimbursement, (ii) are owners of primary residences, and (iii) are qualified senior citizens or disabled persons. To be considered qualified senior citizens or disabled persons, homeowners

must provide proof that they are either (i) 62 years of age or older and meet income and asset limitations, or (ii) certifiably disabled.

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

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

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

## **[C] Discharge of Indebtedness**

### **[1] Defer Taxation of Income; Basis Adjustment**

#### **[b] Solvent Debtors**

#### **Page 69, add the following**

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

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

#### **Page 70, add the following**

#### **[d] Discharge of Indebtedness for Interest**

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

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

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

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

#### **§ 3.08 Appendix—Comparison of Income Tax and Consumption Tax**

##### **[B] Loan**

##### **[2] Comparison of Income Tax and Consumption Tax**

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

##### **Page 79, correction**

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

## Chapter 4

### GIFTS

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#### § 4.04 Death

##### [D] Basis: 2010 and Beyond

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

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

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

##### [E] Gift Tax

##### **Page 87, delete this section and replace with the following**

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

The gift tax exemption should not be confused with the annual per donee gift tax exclusion—which is \$13,000 in 2011 (adjusted for inflation). This exclusion applies to cash gifts of a present interest (not gifts in trust). Thus, a cash gift of \$15,000 uses up the \$13,000 exclusion, leaving \$2,000 to be debited against the \$5 million exemption. (The donor must file a return to claim an exemption, but not the exclusion.) The exclusion applies to each donor and donee, so that a husband and wife can give a total of \$52,000 cash each year to their two children.

## Chapter 5

### TAXABLE YEAR

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#### § 5.05 Income Averaging

##### Page 106, add the following

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

## Chapter 6

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

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#### § 6.01 Legislative Process

##### [C] The Problem of Tax Expenditures

##### [3] Efficiency and Progressive Rates

Page 113, add the following

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

#### § 6.02 Agency Rulemaking

##### [A] Regulations

Page 120, add the following

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

The Court noted that it had sometimes relied in tax cases on the *National Muffler* case, [440 U.S. 472](#), which had been skeptical of regulations that were inconsistent over time, were issued long after the law was enacted, or were a response to litigation. But it concluded that Chevron deference did not rely on these considerations and it then deferred to the Treasury’s Regulation. In reaching its conclusion, the Court made no distinction between rules issued pursuant to the Treasury Department’s general authority to “prescribe all needful rules and regulations for the enforcement” of the tax law (that is, interpretive regulations) and rules “issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision” (that is, substantive regulations).

It also noted that the Treasury Department had “issued the [] rule only after [public] notice-and-comment procedures, again a consideration identified in our precedents as a ‘significant’ sign that a rule merits *Chevron* deference.”

For a thoughtful discussion of what *Mayo* did and did not decide, see Johnson, *Mayo* and the Future of Tax Regulations, [130 Tax Notes 1547](#) (March 28, 2011) (future battlegrounds: regulations not issued after notice and comment; whether and how to take account of any Treasury rationale advanced to support a regulation; application of *Chevron* to sub-Regulation authority, such as a Revenue Ruling).

## **[B] Revenue Rulings**

### **[1] Can Taxpayers Rely on Revenue Rulings?**

**Page 121, add the following**

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

*Retroactive Regulations?* **Section 7805(b)(1)** provides that no Regulation shall apply retroactively (with some exceptions). However, this provision only applies to laws enacted on or after July 30, 1996 (Public Law 104-168, sec. 1101(b)). Whether or not the Treasury can adopt a Regulation retroactively when it is not subject to **§ 7805(b)(1)** remains an open question.

### **[2] Chevron Deference?**

**Page 121, add the following**

In *United States v. Mead Corp.*, [533 U.S. 218](#) (2001), the Court held that *Chevron* deference is appropriate “when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority.” How does that decision apply to Revenue Rulings? The Department of Justice (DOJ) had argued that Revenue Rulings had the force of law under *Mead*, but the appellate section chief of the DOJ announced at a May 2011 meeting of the American Bar Association Section on Taxation that the DOJ would no longer argue that revenue rulings should receive *Chevron* deference.

Presumably the IRS can take a different position in litigation than the DOJ, so the issue remains open. In this connection, what do you make of [Treas. Reg. § 601.601\(d\)\(2\)\(v\)\(d\)](#), stating that “Revenue Rulings [] do not have the force and effect of Treasury Department Regulations [], but are published to provide precedents to be used in the disposition of other cases, and may be cited and relied on for that purpose.” “Precedents” might refer only to agency practice, but the reference to “citing” sounds more like a statement with the force of law.

## **[C] Letter Rulings; TAMs**

**Page 123, add the following**

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

The parties clearly disagree as to the relevance of a private letter ruling, issued by the IRS to one taxpayer, to the litigation of a different tax claim brought by another taxpayer. Plaintiff's argument is founded on assumptions that the court cannot endorse. First, plaintiff states that "[t]he Court of Federal Claims . . . has ruled repeatedly that PLRs can be relevant to ongoing litigation, and many cases have explicitly considered PLRs as evidence." This statement does not give a full picture of this court's, or other courts', consideration of PLRs in tax cases.

[Ed.—The court noted in footnote 6 that plaintiff relies extensively on *IBM v. United States*, [170 Ct. Cl. 357](#), 343 F.2d 914 (1965), a case with thirty negative citing references, and omits any reference to the precedential limitation of the holding of that case to its facts (citations omitted).]

Private letter rulings, like certain other written determinations issued by the IRS, "may not be used or cited as precedent." 26 U.S.C. § 6110(k)(3) (2006). Most courts, therefore, do not find private letter rulings, issued to other taxpayers, to be of precedential value in deciding the tax claims before them (citations omitted).

#### **[D] Other Agency Guidance**

##### **Page 124, add the following**

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

I.R.S. General Counsel Memoranda are informal documents written by the I.R.S. Chief Counsel's office. They provide the Chief Counsel's opinion on particular tax matters before other I.R.S. officials. The Memorandum at issue in this case includes a disclaimer that it is "not to be relied upon or otherwise cited as precedent by taxpayers." As a result, the Memorandum is not entitled to deference under *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.*, [467 U.S. 837](#) (1984), because it is an informal letter that itself renounces any force-of-law effect. See *United States v. Mead Corp.*, [533 U.S. 218, 226-27](#) (2001) (holding that *Chevron* deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority"); *Christensen v. Harris County*, [529 U.S. 576, 587-88](#) (2000) (holding that agency interpretations contained in informal opinion letters are not entitled to *Chevron* deference). Any "respect" afforded to the Memorandum would only be proportional to its "power to persuade" pursuant to *Skidmore v. Swift & Co.*, [323 U.S. 134, 140](#). In this case, we decline to rely on the Memorandum because it disclaims precedential effect and is not entitled to deference under *Chevron*.

## § 6.03 Tax Law Adjudication

### [A] Agency Level

#### Page 124, add the following

Is there an omission from gross income in the nonbusiness context when there is an overstatement of cost? A Supreme Court case arising in the *business* context had interpreted an earlier version of the Code to mean that an overstatement of cost did not constitute an omission from gross income. *Colony v. Commissioner*, [357 U.S. 28](#) (1958). Recent cases had applied that interpretation in the *nonbusiness* context. *See, e.g., Bakersfield Energy Partners v. Commissioner*, [568 F.3d 767](#) (9th Cir. 2009); *Salman Ranch, Ltd. v. United States*, [573 Fed. Cl. 1362](#) (Fed. Cir. 2009). New Regulations reject these cases and determine that an overstatement of cost in the nonbusiness context constitutes an omission from gross income. [Treas. Reg. § 301.6501\(e\)-1\(a\)\(iii\)](#). For example, if a taxpayer claims a \$10,000 cost on the sale of an investment asset for \$10,000, but the correct cost is zero, there is a \$10,000 understatement of gross income. According to the government, the agency was free to issue this new regulation despite the decision in the *Colony* case because a Regulation can override a court decision interpreting a statute (even a Supreme Court decision) if the decision resolves an ambiguity rather than identifies the only unambiguous interpretation of the statute. *National Cable & Telecommunications Ass'n v. Brand X Internet Services* [545 U.S. 967](#) (2005).

In *Home Concrete & Supply, LLC v. United States*, [634 F.3d 249](#) (4th Cir. 2011), the court held that the *Colony* case had concluded that [§ 6501\(e\)\(1\)\(A\)](#) was *unambiguous* on the issue covered by the regulation. Consequently, the agency regulation was not entitled to deference by the courts. This issue will probably reach the Supreme Court.

*Retroactivity.* Even if the Regulation is valid, the courts will still have to decide whether it can be applied retroactively to tax years that remained open when the regulation was proposed, which is what the Regulation provides. [Section 7805\(b\)\(1\)](#) would not prevent retroactivity because the Regulation interpreted a law adopted prior to July 30, 1996.

An important Supreme Court case dealing with retroactive *legislation* is *Landgraf v. USI Film Products*, [511 U.S. 244](#) (1994), which has been applied by the Federal Circuit to tax regulations in *Princess Cruises Inc. v. United States*, [397 F.3d 1358](#) (Fed. Cir. 2005). The Federal Circuit stated the standard for determining whether a regulation was retroactive as follows: “[A] rule or regulation will not be applied retroactively unless the agency clearly intended that the rule have retroactive effect and Congress authorized retroactive rulemaking.” The court then adopted the following three part test to apply that standard: “the nature and extent of the change of the law”; “the degree of connection between the operation of the new rule and a relevant past event”; and “familiar considerations of fair notice, reasonable reliance, and settled expectation.”

The government argues that a Regulation is retroactive if it only “clarifies” prior law, to which the Federal Court responded as follows:

The government focuses its retroactivity arguments on a test it discerns from the Seventh Circuit, in which the court discussed “whether a rule is a clarification or a change in the law.” Under this doctrine, changes, but not clarifications, have retroactive effect. . . . We find the binary analysis—change or clarification—advanced by the government largely unhelpful. Merely categorizing rules or applications of rules as “clarifications” or “changes” provides little insight into whether a retroactive effect would result in a particular case. As noted by the Court of Appeals for the D.C. Circuit, a clarification, in fact, “changes the legal

landscape,” because “a precise interpretation is not the same as a range of possible interpretations.” *Health Ins. Ass'n of Am., Inc. v. Shalala*, [23 F.3d 412, 423-24](#) (D.C.Cir.1994); McCoy, [270 F.3d at 509](#) (noting that the Landgraf factors must be applied because “almost every new statute results in some perceptible effect or impact on countless past or pre-existing choices, decisions, and interests of the actors and subjects in the newly-regulated field”).

Another way to analyze whether an agency regulation can be retroactive is to ask whether a retroactive rule would be an abuse of administrative discretion. See *Grapevine Imports, Ltd. v. United States*, [636 F.3d 1368](#) (Fed. Cir. 2011), where the Federal Circuit stated:

[I]t is clear from the language of the section [precursor to § 7805(b)] and its legislative history that Congress thereby confirmed the authority of the Commissioner to correct any ruling, regulation or Treasury decision retroactively[.] *Auto. Club of Mich. v. Comm'r of Internal Rev.*, [353 U.S. 180, 184](#) (1957). Further, we read Landgraf as emphasizing a requirement of clear Congressional intent for retroactive application. Such an intent was manifest here, by § 7805(b)'s straightforward endorsement of retroactive regulation.

The court went on to uphold the retroactive application of the extended statute of limitations period when the taxpayer overstated basis, as follows:

We [] must determine whether it was an abuse of discretion for the Treasury Department to state that the new regulations would apply to preceding tax years. We conclude that it was not. . . . [T]he new regulations are a reasonable interpretation of the limitations statutes. By their terms, the new regulations will apply only to those taxpayers who are within the limitations period as computed under the new regulation, so there is no opportunity for these regulations to reach into the distant past. And while we recognize that some taxpayers whose past returns bear evidence of overstated basis may find themselves facing adjustments when they thought the limitations period had lapsed, we cannot say that the burden on those taxpayers is so great as to be an abuse of the Treasury Department's discretion. We therefore conclude that the new regulations may properly be applied to returns from past tax years whose limitations periods (as recomputed) has not yet expired.

## **[B] Court Level**

### **Page 126, add the following**

An intriguing question is whether different courts are disposed to take different approaches to interpreting the income tax code. In *Shores, Textualism and Intentionalism in Tax Litigation*, 61 *Tax Lawyer* 53 (2007), the author looked at how the Tax Court and the Courts of Appeals dealt with ten cases in which there was a clear difference in result depending on whether the court deferred to the plain meaning of the text or relied on other evidence of legislative intent. The finding was that the Tax Court relied on intent in every such case, but the Courts of Appeals relied on plain meaning.

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

## **§ 6.04 Ethical Responsibilities of a Representative**

### **[B] Related Penalties**

#### **[1] Substantial Understatement Penalty**

##### **Page 128, add the following**

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

In the circumstances presented here, reliance on [Ernst & Young’s] advice was not reasonable. As the Federal Circuit stated in [another case]: “Reliance is not reasonable, for example, if the adviser has an inherent conflict of interest about which the taxpayer knew or should have known.” The Murphys could not reasonably have expected to receive independent advice from the same firm that was selling them [a tax shelter]. Because Ernst & Young had a financial interest in having the Murphys participate in [the tax shelter], the firm had an inherent conflict of interest in advising on the legitimacy of that transaction.

That conflict of interest was exacerbated by the fee structure. The Murphys have conceded that from the beginning they understood that Ernst & Young’s fee would be a percentage of their desired tax loss. (“The Murphys believed initially that the fees for [tax shelter transaction] were to be 4.5% of the tax benefits or tax savings from the [] transaction.”). In other words, the Murphys understood that the more taxes they avoided by following Ernst & Young’s advice the more they would pay [] in fees. The Murphys knew that Ernst & Young stood to earn millions by advising them to participate in [the tax shelter], and they therefore knew or should have known that Ernst & Young’s advice lacked the trustworthiness of an impartial opinion. Given Ernst & Young’s obvious conflict of interest, reliance on its advice does not demonstrate that Murfam acted with reasonable cause or in good faith.

#### **[2] Return Preparer Penalty**

##### **Pages 128-129, add the following**

For tax returns prepared after May 25, 2007, the standards for the return preparer penalty have been revised to conform to standards applicable to the substantial understatement penalty. For undisclosed positions, substantial authority will suffice (reduced from the “more likely than not” standard). For disclosed positions, a reasonable basis standard applies. This provision appears in as 2008 law (the Tax Extenders and AMT Relief Act of 2008). **§ 6694(a)(2)**.

## Chapter 7

### INCOME IN-KIND

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#### § 7.02 Employee Fringe Benefits

##### [C] The Statutory Exclusion Rules

##### [3] Parking

###### Page 143, add the following

The inflation-adjusted amount that can be excluded as a parking fringe benefit is **\$230** per month for 2011.

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

Another tax break related to driving to work is the exclusion from income of the value of van pooling in commuter highway vehicles (with a seating capacity of six or more) and of transit passes. This exclusion is subject to a dollar ceiling, which has been increased to equal the amount excluded as a parking fringe benefit (until the end of 2012).

##### [E] Cafeteria Plans

###### Page 145, add the following

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

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

## Chapter 8

### DEDUCTIONS FROM INCOME

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#### § 8.01 Introduction

##### [A] Statutory Rules

###### Page 151, add the following

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

###### Page 152, add the following

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

Before 1988 petitioner worked as a contract attorney performing various legal services, e.g., researching legal issues, attending hearings, etc., on behalf of other attorneys. She represented her own clients on occasion, but this was rare. . . . From 1988 until her employment was terminated in 2000 she worked as a securities regulator for the California Department of Corporations (the department). Petitioner worked as a contract attorney again in 2000 but not at all during 2001 and 2002.

In 2003 petitioner decided once again to try to work as a contract attorney. She attended the ABA 2003 Midyear Meeting in Seattle, Washington, on February 8-11. While there she attended a women's caucus luncheon, a solo and small firm lawyers breakfast caucus, and seminars on securities law. Petitioner networked with colleagues and informed them she was available as a contract attorney to perform various legal services on their behalf. Petitioner also purchased various supplies, including a computer, printer, paper products, etc., as well as telephone, fax, and Internet services between January and March 2003. Petitioner attempted to be reinstated as a securities regulator by the department and eventually filed suit against the department in 2003. She used some of the supplies she had purchased to assist in her reinstatement efforts. Before petitioner secured any clients or earned any income as a contract attorney in 2003, she was reinstated by the department and returned to work on or around March 25.

The court rejected the taxpayer's argument that her "activity was a continuation of a trade or business carried on previously; i.e., in the 1980s and in 2000. [E]ven if her activities in the past amounted to a trade or business, which we do not decide, there was a substantial lack of continuity between her prior work and her efforts in 2003. Petitioner did not work as a contract attorney between 1988 and 2000 while she worked for the department. She also did not work as a contract attorney in 2001 or 2002, and her activity in 2003 was sporadic. Accordingly, under the facts of this case petitioner's activity in 2003 was not a continuation of a trade or business carried on in any

previous period.”

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

### **§ 8.03 Dependent Care**

#### **[A] Modern Statutory Rules**

##### **Page 161, add the following**

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

### **§ 8.04 Traveling Expenses**

#### **[A] Meals and Lodging**

#### **[3] Temporary Worker**

##### **Page 168, add the following**

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

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

The problem with the Tax Court's distinction is that work can be, and usually is, both temporary and indefinite, as in our lawyer example. A lawsuit he is trying in London might settle on the second day, or last a month; his sojourn away from his office will therefore be both temporary and indefinite. Indeed all work is indefinite and much “permanent” work is

really temporary. An academic lawyer might accept a five-year appointment as an assistant professor with every expectation of obtaining tenure at the end of that period at that or another law school; yet one would not describe him as a “temporary” employee even if he left after six months and thus was not barred from claiming temporary status by the one-year rule. . . .

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

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

If this seems rather a mechanical reading of the statute, it has the support . . . of the even more influential precedent of *Commissioner v. Flowers*, [326 U.S. 465](#) (1946), where the Supreme Court said that “the exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors” in the decision to travel. The “business exigencies” rule, though harsh, is supported by compelling considerations of administrability. To apply a test of reasonableness the Internal Revenue Service would first have to decide whether the taxpayer should have moved to his new place of work. This might require answering such questions as whether the schools in the area of his new job were far worse than those his children currently attend, whether his elderly parents live near his existing home and require his attention, and whether his children have psychological problems that make it difficult for them to find new friends. . . .

We are sympathetic to Wilbert's plight and recognize the artificiality of supposing that, as the government argues, he made merely a personal choice to “commute” from Minneapolis to Anchorage, and Chicago, and New York, as if Minneapolis were a suburb of those cities. But the statutory language, the precedents, and the considerations of administrability that we

have emphasized persuade us to reject the test of reasonableness. The “temporary versus indefinite” test is no better, so we fall back on the rule of Flowers and Hantzis that unless the taxpayer has a business rather than a personal reason to be living in two places he cannot deduct his traveling expenses if he decides not to move. Indeed, Wilbert's situation is really no different from the common case of the construction worker who works at different sites throughout the country, never certain how long each stint will last and reluctant therefore to relocate his home. The construction worker loses, as must Wilbert. E.g., *Yeates v. Commissioner*, [873 F.2d 1159](#) (8th Cir.1989).

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

#### **[5] Introductory Language of § 162**

##### **Page 169, add the following**

IRS [Notice 2007-47](#), 2001-1 C.B. 1393, states that “§ 1.262-1(b)(5) of the Income Tax Regulations provides that the costs of a taxpayer's lodging not incurred in traveling away from home are personal expenses and are not deductible unless they qualify as deductible expenses under § 217.” It then states that “the Service will not apply § 1.262-1(b)(5) to expenses for lodging of an employee *not* incurred while the employee is traveling away from home that an employer provides to the employee, or requires the employee to obtain, under the following conditions: (1) The lodging is on a temporary basis; (2) The lodging is necessary for the employee to participate in or be available for a bona fide business meeting or function of the employer; and (3) The expenses are otherwise deductible by the employee, or would be deductible if paid by the employee, under § 162(a).” In other words, the IRS now seems willing to permit a deduction for lodging under the specified circumstances—even though the taxpayer is not away from home—presumably by applying the introductory language of **§ 162**. The Notice would probably apply to someone who lived in the suburbs but who has to stay overnight in the city on an occasional basis for a meeting.

#### **§ 8.08 Estate Planning and Tax Determination Expenses**

##### **[B] Burden of Proof**

##### **Page 180, add the following**

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

#### **§ 8.09 Business as Pleasure**

##### **[A] In General**

## COMMENTS AND QUESTIONS

### Page 181, add the following

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

## Chapter 9

### **PERSONAL INSURANCE PROTECTION AND PERSONAL LOSSES**

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#### **§ 9.01 Insurance Protection**

##### **[B] Employer-Purchased Insurance**

##### **[2] Medical and Disability Insurance**

##### **Page 186, add the following**

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

#### **§ 9.02 Personal Losses**

##### **[B] Uncompensated Losses**

##### **[1] Medical Expenses**

##### **Page 188, add the following**

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

##### **Page 190, add the following**

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

8. *Insurance premiums.* The health care reform law—Public Law 111-148, entitled The Patient Protection and Affordable Health Care Act, and the amendments in Public Law 111-152, entitled the Health Care and Reconciliation Act of 2010—require individuals without health insurance coverage to purchase insurance beginning in 2014 or else pay a penalty. The financial burden of purchasing the insurance will be reduced by a refundable health care premium credit (**§ 36B**) for taxpayers with income falling between 100% and 400% of the poverty level.

In addition, a complex provision provides “small businesses” with a credit to offset some of the cost of buying health insurance for employees. A business is eligible for this credit if it has no more than 25 full-time equivalent employees and the average annual pay is less than \$50,000 per employee. **§ 45R** (small employer health insurance credit). The credit is not available for insurance purchased for self-employed individuals or for 5% owners of a small business.

**Page 191, add the following**

2a. *Sex change. O'Donnabhain v. Commissioner*, [134 T.C. 34](#) (2010), held that the cost of sex-change surgery and related feminizing hormones were, on the facts, deductible medical expenses. Regulations under **§ 213** included mental illness as a disease for which the taxpayer could incur deductible medical expenses; and the taxpayer had what the Diagnostic and Statistical Manual of Mental Disorders labeled a “genetic identity disorder (GID).” The court rejected the government’s argument that GID was a “social construction” and “not a significant psychiatric disorder.” The exclusion from deductible medical care for cosmetic surgery did not apply to the taxpayer because the taxpayer’s expenditures were to “treat illness or disease,” as provided by **§ 213(d)(9)(B)**.

**[2] Medical Savings Accounts and Health Savings Accounts**

**Page 192, add the following**

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

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

**Page 193, add the following**

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

**§ 9.03 Tort Recoveries**

**[A] Physical and Nonphysical Injury**

**[2] Emotional Distress?**

**Page 196, add the following**

In *Sanford v. Commissioner*, [95 T.C.M. \(CCH\) 1618](#) (2008), affirmed, [105 A.F.T.R.2d 2010-1130](#) (6th Cir. 2010), the taxpayer recovered damages arising from unlawful employment discrimination

(sexual harassment). The court concluded that the damages were taxable, stating that it was “evident from the [agency] decision that none of the award was predicated on personal physical injury or physical sickness as the statute requires.” Although “the emotional distress manifested itself in physical symptoms such as asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression[, t]hese physical symptoms were not the basis of the award petitioner received. [Taxpayer] sought, and was awarded, relief for sexual harassment, discrimination based on sex, and the failure of the [employer] to take appropriate corrective action. . . . Damages received on account of emotional distress, even when resultant physical symptoms occur, are not excludable from income under section 104(a)(2).”

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

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

In its affirmance, the Court of Appeals stated that “the mere fact that false imprisonment involves a physical act—restraining the victim’s freedom—does not mean that the victim is *necessarily* physically injured *as a result of* that physical act.

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

## Chapter 10

### CHARITY

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#### § 10.01 Charitable Deductions

##### [C] Mechanics

##### Page 207, add the following

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

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

#### § 10.02 Tax-Exempt Organizations

##### [A] In General

##### Page 209, add the following

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

#### § 10.03 Defining “Gifts”

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

##### Page 220, add the following

4. In *Free Fertility Foundation v. Commissioner*, [135 T.C. No. 2](#) (2010), the taxpayer organized a non-profit corporation to provide the taxpayer's sperm free-of-charge to those women who requested this service. The court stated that

[t]he free provision of sperm may, under appropriate circumstances, be a charitable activity. Petitioner, however, does not qualify for tax exemption because the class of petitioner's beneficiaries is not sufficiently large to benefit the community as a whole. Petitioner contends that “the class of individuals that could be direct beneficiaries of petitioner is extremely large: all women of child-bearing age.” To the contrary, the class of potential

beneficiaries includes only the limited number of women who are interested in having one man—“Naylor”—be the biological father of their children and who survive the very subjective, and possibly arbitrary, selection process controlled by the Naylors. Over a 2-year period, petitioner received 819 inquiries and provided sperm to 24 women. In deciding who receives the sperm, petitioner has certain preferences that narrow the class of eligible recipients. It is not apparent what, if any, relationship some of these preferences have to the promotion of health. For example, petitioner prefers women “from families whose members have a track record of contributing to their communities” and women “with better education.”

### **[C] The Religious Quid Pro Quo**

#### **[2] Religious School Tuition**

**Page 224, add the following**

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

### **§ 10.04 Noncash Gifts**

#### **[A] Appreciated Property**

**Page 225, add the following**

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

## Chapter 11

### DEPRECIATION

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#### § 11.03 Other Investment Incentives

##### [A] Expensing and Short-Period Depreciation

###### Page 244, add the following

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

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

##### [2] Section 179

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

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

Absent any further change in the law, the amount that can be expensed under **§ 179** in 2012 is \$125,000 and the threshold above which the amount that can be expensed begins to disappear is \$500,000—dropping to \$25,000 and \$200,000 respectively after 2012. We might wonder why the otherwise-generous provisions of the 2010 Tax Relief Act did not extend the higher dollar levels for 2012 and beyond. Perhaps there was a desire not to increase budget deficit projections based on this tax break, especially when it is expected that (in any event) the political climate will end up extending the benefits.

##### [B] Tax Credits

###### Page 245, delete the paragraph “Other business credits” and replace with the following

**Other business credits.** The tax credit mechanism (as well as accelerated depreciation) remains popular for specific investments—on either a temporary or permanent basis. For example, there is now a credit for housing rehabilitation (**§§ 38(b)(1), 46(1), 47**) and investment in low income housing (**§ 42(a)**). The orphan drug credit was extended by the 1996 Act and made permanent by the 1997

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

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

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

However, the 2010 Tax Relief Act did not extend these benefits through 2012. For 2012, the figures revert to earlier levels (**\$12,170** of adoption expenses eligible for the credit, adjusted for post-2010 inflation); and the phase-out threshold is **\$182,520**. The relevant code section will be **§ 23**.

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

## Chapter 12

### LOSSES

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#### § 12.02 Personal Assets

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

###### Page 252, add the following

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

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

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

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

Finally, the ruling dealt with the sale of term insurance—hypothesizing a level premium fifteen-year term life insurance contract without cash surrender value in which the monthly premium was \$500. Through June 15 of Year 8, the taxpayer paid premiums totaling \$45,000 and, on June 15 of Year 8, taxpayer sold the life insurance contract for \$20,000. The cost basis was \$250, which was the amount of the premium attributable to the second half of June; that is, the period *after* the sale for which the taxpayer received no insurance protection. This portion of the ruling was also prospective.

#### [4] Further Limits on Loss Deduction of Personal Use Assets

##### Page 254, add the following

The excess-of-10% requirement for the casualty loss deduction for personal use assets is waived, if the loss is attributable to a federally declared disaster during 2008-2009.

##### Page 256, add the following

#### § 12.05 “Madoff” Losses

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

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

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

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

## Chapter 13

### CAPITAL EXPENDITURE VS. CURRENT EXPENSE

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#### § 13.02 Acquisition Costs

##### [E] Elective Amortization—Section 195

##### Page 263, add the following

Beginning in 2010, the amount of deductible start-up business costs for investigating or creating a business that can be expensed is increased to \$10,000 and the phase-out begins when such expenditures exceed \$60,000.

#### § 13.03 Repair/Maintenance Expenses vs. Costs for Improvements and Acquisitions

##### [A] Tangible Property

##### [2] Deductible Repair Expense or Capital Improvement Cost

##### [c] Environmental Clean-Up

##### Page 278, add the following

The permission to expense “qualified clean-up costs” under § 198 has been extended through 2012.

##### [B] Intangible Property; “Future benefits”

##### Page 285, add the following

##### [4] Defending title

In *Wellpoint, Inc. v. Commissioner*, [599 F.3d 641](#) (7th Cir. 2010), Judge Posner discussed the distinction between a capital expenditure and a current expense in the context of a taxpayer’s defense of title. The court held that the expenditures were in defense of title and therefore capital expenditures, as follow:

We’ll begin our analysis by explaining, with the aid of examples, the difference between a capital expenditure and an ordinary and necessary business expense. The cost of buying a building is a capital expenditure because a building has “a useful life substantially beyond the taxable year,” Treas. Reg. § 1.263(a)-2(a), which is the general understanding of “capital expenditure.” A capital expenditure is not deductible as a business expense in the year in which it is made; instead it must be depreciated over its useful life, and the amount of depreciation each year is all that is deductible that year. In this way, cost is matched temporally with revenue, which is a desideratum of tax law. The purchase price of a capital asset is not the only example of a capital expenditure. *Any* expenditure is capital if its “utility

... survives the accounting period” in which it is made. So an expense incurred to enhance the value of a capital asset must be capitalized, and thus amortized over the asset’s remaining life. . . .

Just as repairs prevent a building from collapsing, so expenditures to defend title to the building (maybe someone is seeking specific performance of what he claims, and you deny, is your agreement to sell him the building) are incurred to protect the building against what from the owner’s standpoint might be a loss equivalent to its collapsing. But such expenditures, because incurred to defend (or assert) the ownership of a capital asset, cannot be expensed. The distinction may seem tenuous, but it is well established.

The particular expenses involved in this case were incurred in defending a lawsuit. A business that is sued for unpaid taxes, say, or unpaid rent, is allowed to deduct its expenses in defending the suit as “ordinary” business expenses. They are the sort of expense that is incurred to preserve the operation and profitability of the business rather than to acquire or retain or improve a specific capital asset, and thus are “ordinary and necessary” even though they are not as regular and predictable as costs of labor and materials. Such disputes over characterization are resolved by application of what is called the “origin of the claim” doctrine: costs incurred in defending a lawsuit are classified as expenses or as capital expenditures depending on the nature of the claim that gave rise to the litigation.

In our hypothetical building-code case the landlord’s litigation expenses were in lieu of proper maintenance, so they are treated like the repair expenses for which they are a substitute, and thus can be expensed. But if the landlord were defending against a suit for specific performance of a contract to sell the building, he would be defending the ownership of his capital asset and so the origin of the claim would be a dispute over title.

WellPoint claims that the cost of the settlement . . . were “ordinary” because it was defending against claims that it was using its property—the assets of the acquired [Blue Cross Blue Shield] companies—improperly. On this view, WellPoint was like a landlord who is sued for violating the building code by failing to maintain his building properly. But the government argues that WellPoint was defending its title to the acquired assets, and we said that expenses incurred in defending title to a capital asset are not ordinary expenses. WellPoint ripostes that the attorneys general never questioned its title but merely its use of the assets for profit-making rather than charitable purposes.

In each of the three suits out of which the present dispute arises WellPoint had acquired assets that were held in a charitable trust. Two of the suits asked that the assets be taken out of WellPoint’s hands entirely and placed in charitable entities with which WellPoint would have nothing to do. The third, the Ohio suit, asked that the assets be placed in a charitable trust but left open the possibility that WellPoint might be the trustee. But whether the origin of a claim is a dispute over a capital asset or over the day-to-day operations of the business is not to be decided by reference to the outcome of the suit. Otherwise, as the Supreme Court explained in the Gilmore case, “if two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstance of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or

nonincome-producing property. We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation.”

The remedy that the parties to a lawsuit seek, obtain, or agree on if they settle the case will sometimes be unrelated to the nature of the claim out of which the suit arose . . . . Still, the remedy sought or ordered or agreed to can be a clue to the nature of the claim. [In this case the], attorneys general were trying to strip WellPoint of its equitable ownership—its right to use the acquired assets for profit. . . .

#### **§ 13.04 Education Expenditures**

##### **[A] Trade or Business Expenses?**

##### **[5] Employer Fringe Benefit**

**Page 289**

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

##### **[B] Scholarships**

##### **[1] Services Required as a Condition of Scholarship**

**Page 290**

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

##### **[C] Education Tax Subsidies**

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

**Page 292, add the following**

The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) makes several changes to the Hope Scholarship credit for 2009 and 2010 (referred to as the American Opportunity Tax Credit)—extended to 2012 by the 2010 Tax Relief Act. The amount of the credit is 100% of the first \$2,000 of qualified tuition and related expenses (which will include course materials) and 25% of the next \$2,000. The credit also applies to the first *four* years of post-secondary education. In addition, 40% of this credit is now refundable. The phase-out threshold is increased so that it will begin at **\$80,000** for a single taxpayer and **\$160,000** for a married couple (but is not adjusted for inflation).

The lifetime learning credit phase-out thresholds are different and are adjusted for inflation. For 2011, the phase-out threshold is **\$51,000** (single) and **\$102,000** (married).

##### **[2] Coverdell Education Savings Accounts; Section 530**

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

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

**Page 294**

The section 222 deduction has been extended through 2011.

## Chapter 14

### PUBLIC POLICY

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#### § 14.01 Ordinary, Necessary, Reasonable, Lavish

##### [B] Excessive Compensation—Reasonable Salary

##### [2] Employees and Owners

##### [a] Multi-Factor Test

##### Page 303, add the following

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

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

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

##### Page 304, add the following

##### [c] Financial Institutions Selling “Troubled Assets”

When Congress appropriated billions of dollars to purchase “troubled assets” held by financial institutions (the so-called TARP program), it also passed new rules dealing with executive compensation paid by these institutions. The rules have two parts. First, compensation is limited for senior executive officers when the institution sells troubled assets directly to the Treasury. Second, there are limits on the deduction of such compensation if the institution sells these assets through a public auction and total sales exceed \$300 million. Among the rules is a \$500,000 limit per year on the deduction of executive compensation, which (unlike the rules in § 162(m)) includes performance-based compensation, such as stock options.

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

#### **[d] Compensation Paid by Health Insurance Providers**

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

#### **§ 14.02 Illegal Activity**

##### **[D] Costs—Defining “Gross Income”**

##### **Page 309, add the following**

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

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

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

## Chapter 15

### **EXEMPT REIMBURSEMENTS**

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#### **§ 15.04 Exempt Reimbursements**

#### **COMMENTS AND QUESTIONS**

#### **Page 327, add the following**

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

## Chapter 16

### LIMITING THE INTEREST DEDUCTION

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#### § 16.01 Personal Loans

##### [C] Statutory Rules

##### [1] Qualified Residence Interest

###### Page 331, add the following

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

##### [3] Student Loans

###### Page 332, add the following

The tax benefits for student loans have been extended through 2012 by the 2010 Tax Relief Act. For 2011, the phase-out thresholds above which the tax break begins to disappear are: single taxpayer (**\$60,000**); married taxpayers (**\$120,000**). These figures reflect an expansion of the student loan interest deduction, which had been scheduled to expire after 2010. In addition, the repeal of the 60-month limit on the number of months for which the interest is deductible has also been extended through 2012.

#### § 16.04 Economic Reality

##### [B] Note on Statutory Interpretation—Tax Avoidance

###### Page 344, add the following

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

Prior case law regarding the economic substance doctrine was unclear. Some cases recognized a

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

Several features of this law cause concern:

- First, the statutory terms “meaningful” and “substantial” are unclear.
- Second, the statute is written in the conjunctive—requiring both economic substance and a business purpose.
- Third, the penalties are substantial. Tax understatements resulting from transactions that fail the statutory test will be subject to a 40% strict liability penalty if they are not disclosed by the taxpayer, 20% if there is disclosure. **§ 6662(b)(6), (i)**. There is no reasonable cause exception so opinions given by tax advisors will not prevent the penalty. **§ 6664(c)(2),(d)(2)**.
- Fourth, the method of determining the profit potential to prove economic substance and business purpose is unclear. The legislative history states that “if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit.” An earlier version of the law explicitly used the low risk-free rate of return as the discount rate used to compute present value, which was a pro-taxpayer provision. (The lower the discount rate the higher the present value of the expected pre-tax profit.) The legislation that passed is silent regarding the discount rate.

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

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

Many tax avoidance transactions are too complex to be considered in a basic tax course. However, the next chapter will consider sale-leaseback transactions and the legislative history of the new law clearly states that “[l]easing transactions . . . will continue to be analyzed in light of all the facts and circumstances.” Such transactions will therefore remain vulnerable under the economic substance

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

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

## Chapter 17

### LOANS, BASIS, AND TAX SHELTERS

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#### § 17.04 Tax Ownership

##### [B] Cases

Page 365, add the following

#### COMMENT

*Tax-exempt seller-tenant.* A question that should occur to someone examining a sale-leaseback arrangement is why the seller-tenant does not keep the property and use the deductions associated with owning the property (depreciation and interest), rather than selling the property to someone else who uses those deductions. The answer is that the seller-tenant is usually less able to use the deductions than the buyer-lessor—e.g., because it is in a lower tax bracket or has net operating losses. In one situation, the tax law (as of 2004) prohibits a buyer-lessor from taking a deduction for depreciation and interest in excess of rent where the seller-tenant is (obviously) unable to use the deductions—that is, when the seller-tenant is a tax-exempt entity (including a government). **§ 470.**

## Chapter 18

### ALTERNATIVE MINIMUM TAX

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#### § 18.02 Mechanics

##### [B] Tax Base

##### [1] Individuals and Corporations

##### Page 382, add the following

The American Recovery and Reinvestment Act of 2009 (the Obama stimulus law) provides that tax-exempt interest on private activity bonds are not a preference item under the AMT for 2009 and 2010, but this provision has expired.

##### [C] Exemptions—§ 55(d)

##### [1] Amounts

##### Pages 383-384, add the following

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

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

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

##### [3] Kiddie Tax

##### Page 384, add the following

The AMT exemption amount for any child subject to the kiddie tax is limited to earned income plus **\$6,800** for 2011.

##### [D] Credits

##### Page 384, add the following

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

## Chapter 20

### CAPITAL GAINS AND LOSSES—DEFINITION

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#### § 20.06 Case Law Limits on Capital Gains

##### [E] Sale of Lottery Winnings

#### COMMENTS

##### Page 425, add the following

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

## Chapter 22

### CARVED OUT INCOME INTERESTS

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#### § 22.02 The Solutions

##### [C] Other Carve Out Situations

##### [2] No Statutory Provision

##### Page 450, add the following

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

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

## Chapter 24

### CASH METHOD

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#### § 24.06 Qualified Retirement Plans

##### [B] No Tax Now; Taxable Later

##### [2] Traditional IRAs

##### Page 477, add the following

The \$5,000 maximum annual deduction for contributions to a traditional IRA is adjusted for inflation beginning in 2009 (rounded down to the nearest \$500). There is no change in the maximum deduction for 2011.

For a taxpayer who *is* an active participant in a qualified retirement plan, the inflation-adjusted income phase-out range for 2011 is **\$56,000-\$66,000** for single taxpayers and **\$90,000-\$110,000** for married couples.

If the taxpayer is *not* a participant in a qualified retirement plan but the spouse is an active participant, the inflation-adjusted phase-out range for 2011 is **\$169,000-\$179,000**.

##### Page 477, add the following

##### [5] Qualified Charitable Distributions from IRAs

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

##### [C] Nondeductible Now; Exempt Later

##### [1] Roth IRAs

##### Page 478, add the following

For 2011, the inflation-adjusted phase-out threshold above which the tax break for contributions to a Roth IRA begins to disappear is **\$107,000** for single taxpayers and **\$169,000** for married couples.

## Chapter 25

### ACCRUAL METHOD

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#### § 25.01 Income

##### [B] When Cash Is Received

##### [2] Post-AAA Developments

#### COMMENTS AND QUESTIONS

##### Page 493, add the following

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

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

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

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

## § 25.02 Deductions

### [B] Before Cash is Paid

#### [3] Statutory and Regulatory Solutions—Economic Performance

Page 498, add the following

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

## Chapter 26

### PROPERTY TAX

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#### § 26.05 Federal Constitutional Rules

##### [C] Equal Protection

#### COMMENT

##### Page 515, add the following

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

We find that our decision in [an earlier case] controls here. That case involved a taxpayer challenge to a “rolling reappraisal” method of assessment in which every two years the town would reassess only that class of property determined by the State Tax Department to be “most in need”—i.e., where on average there was the greatest percentage discrepancy between the listed value of the properties in the class and their fair market value. The taxpayers argued [] that this “rolling reappraisal” method violated the Proportional Contribution Clause [which imposed the same standard as the federal Equal Protection Clause]. . . . [W]e concluded that the town's actions had a rational basis—“keeping appraisals as current as possible within the resources available by attacking the worst underassessment problem areas.” . . .

The appropriate standard of review is whether the difference in treatment between newer and older owners rationally furthers a legitimate state interest [citing *Nordlinger v. Hahn*, [505 U.S. 1](#) (1992)]. In general, the Equal Protection Clause is satisfied so long as there is a plausible policy reason for the classification, the legislative facts on which the classification is apparently based rationally may have been considered to be true by the governmental decisionmaker, and the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational. This standard is especially deferential in the context of classifications made by complex tax laws. [I]n structuring internal taxation schemes the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation. Based on this deferential standard, we have no problem concluding that the freeze is constitutional. . . .

Here, the State argues that the freeze has a rational basis: ensuring temporary stability of tax revenues in a number of small Vermont towns, in the face of difficulties in determining the fair market value of hydroelectric facilities brought about by the “changing and deregulated utility market.” We agree with the trial court that this purpose “is certainly legitimate and important, and is arguably compelling.”

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

## **§ 26.06 Valuation Methods**

### **[D] Specific Problems**

#### **[1] Prestige Buildings**

##### **Page 520, add the following**

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

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

#### **[2] Property Subject to Burdens**

##### **[c] Easements**

###### **[i] Additive Approach**

##### **Page 522, add the following**

In *Breezy Knoll Association, Inc. v. Town of Morris*, [946 A.2d 215](#) (Conn. 2008), the court dealt with the tax on property owned by a homeowners association—specifically: common areas adjacent to homes owned by the association's resident members. The homeowners had an easement of passage and use over the common areas, which consisted of tennis courts, a parking lot, and a lakefront strip. The court concluded that the easements should reduce the property tax value of the common areas (the servient property) and increase the value of the adjacent homes (the dominant estate), which is consistent with the additive approach. The court rejected the argument "that the question of whether to assess the value of the commonly used properties against either an association or its members is merely a semantic one," noting that if "the value properly attributable to the homeowners' properties

[is instead] attributed to association properties, it deprives the homeowners of the benefit of a deduction, for federal income tax purposes, of the property taxes the homeowners effectively are responsible for paying.”

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

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

**Chapter 27**

**ESTATE AND GIFT TAX**

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**§ 27.02 Gift Tax**

**[C] Exclusions**

**Pages 526-27, add the following**

The inflation-adjusted gift tax exclusion amount is **\$13,000** for 2011.

## Chapter 28

### SOCIAL SECURITY TAX

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#### § 28.01 In General

##### Page 539, add the following

The inflation adjusted maximum earnings subject to the social security tax for 2011 is **\$106,800**.

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

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

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

#### § 28.02 Wages

##### [B] Severance Pay for Teachers

### COMMENTS AND QUESTIONS

##### Page 544, add the following

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

## **§ 28.03 “Employee”**

### **[A] Common Law Standard**

#### **[2] Applying the Factors**

**Page 554, add the following**

#### **[e] Massage Therapists**

In *Mayfield Therapy Center v. Commissioner*, [100 T.C.M. \(CCH\) 376](#) (2010), the court considered whether massage therapists were employees or independent contractors, as follows:

Ms. Mayfield is a licensed massage therapist. During 2002 she operated the therapy center and a massage school at separate locations in Ardmore, Oklahoma. . . . The facilities at each location included a reception area in the front and workstations for cosmetologists and nail technicians. (Hereinafter we refer to the cosmetologists and nail technicians collectively as cosmetologists and sometimes refer to the cosmetologists, nail technicians, and massage therapists collectively as service providers.) . . .

The service providers received no set salary or wages and no fringe benefits. As a general rule, the spa charged each service provider weekly “booth rent” equal to the greater of approximately \$80 “base rent” or 25 percent of the gross revenues the service provider generated that week. But the spa's practices varied. . . . The service providers set their own hours. Some of them worked full time; others were part-time workers who were students or had jobs elsewhere. . . . Petitioners had written agreements with some service providers, at least for some years at issue, but not with others. . . . [S]ervice providers without written agreements generally gave the spa advance notice of the days and hours they planned to be at the spa. But the service providers often altered their schedules as they chose and were free to leave the spa during the hours they had scheduled for themselves. . . .

Clients made appointments for spa services at the receptionist's desk. A receptionist or Ms. Mayfield generally answered the telephone, or if they were unavailable, one of the service providers would answer it. If the client requested a particular service provider, the request was honored. If the client requested no particular service provider, the receptionist would rotate scheduling among available service providers. A service provider could decline servicing any particular customer. . . . The spa posted prices for various spa services on brochures and on its Internet site. But the service providers were not required to charge these posted prices; they often charged less and occasionally provided free services for repeat customers, family, and friends.

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

participating service providers. A service provider's participation in "spa parties" was voluntary. . . .

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

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

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

The weekly payment arrangement also reflected, in addition to the spa's retention of rent, compensation of the service providers on a straight commission basis, with no minimum guaranteed level of payment. This circumstance also counts in favor of independent contractor status, as does the fact that the spa provided the service providers no employee benefits, such as vacation or sick leave.

Respondent concedes that the spa did not pay service providers' business or travel expenses and that this circumstance supports independent contractor status. In addition, it appears that many of the massage therapists made significant investments in outfitting and decorating their massage rooms. These various circumstances, coupled with the spa's right to collect minimum fixed rent each week, also lead us to conclude that service providers bore the risk of suffering net losses, and in some weeks did suffer net losses, from their operations

at the spa. Conversely, the service providers had opportunities to profit by working longer hours, at times coming into the spa for appointments outside the spa's normal business hours. Finally, on the basis of the testimony of several service providers, it appears that they believed that they had a nonemployee relationship with the spa. All these considerations support a finding of independent contractor status.

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

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

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

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

at the spa for several years, the work relationship was not necessarily permanent or indefinite, as indicative of employment status. Consequently, we also regard this factor as neutral.

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

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

### **Page 555, add the following**

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

### **Page 555, add the following**

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

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

The Court noted that it had sometimes relied in tax cases on the *National Muffler* case, [440 U.S. 472](#), which had been skeptical of regulations that were inconsistent over time, were issued long after the law was enacted, or were a response to litigation. But it concluded that Chevron deference did not rely on these considerations and it then deferred to the Treasury's Regulation. In reaching its conclusion, the Court made no distinction between rules issued pursuant to the Treasury Department's general authority to "prescribe all needful rules and regulations for the enforcement" of the tax law (that is, interpretive regulations) and rules "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision" (that is, substantive regulations).

It also noted that the Treasury Department had “issued the [] rule only after [public] notice-and-comment procedures, again a consideration identified in our precedents as a ‘significant’ sign that a rule merits Chevron deference.”

## Chapter 29

### SALES TAX

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#### § 29.03 Tax Base

##### [B] Primarily Tangible Personal Property

##### [5] Progressivity

##### Page 560, add the following

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

#### § 29.04 Taxable Sales of Tangible Personal Property

##### [B] Tangible or Intangible Property

##### Page 566, add the following

##### COMMENT—"COMMON UNDERSTANDING"

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

Whether couched in terms of the true object, dominant purpose, or essence of the transaction, or of the consequential or incidental nature of the transfer of tangible property, the rationales of most courts attempting to characterize inseparably mixed transactions

acknowledge, either explicitly or implicitly, that they are not reducible to a single, dispositive factor. While there has been no clear emergence of a comprehensive and consistent theory that more expressly articulates the goals of the analysis, a veritable plethora of factors have been relied on under the circumstances of individual cases. . . .

Varied as these analyses may be, they largely share in common some attempt to identify characteristics of the transaction at issue that make it either more analogous to what is reasonably and commonly understood to be a sale of goods, or more analogous to what is generally understood to be the purchase of a service or intangible right. Perhaps the quintessential transaction for the purchase of an intangible right is the marketing of literary works, in which the clear object, around which the entire transaction is structured, is the right to publish the author's work. Although the transactions by Leanin' Tree may superficially appear to be akin to the purchase of artwork, which is normally considered to be the sale of a tangible object, upon closer examination the transactions between Leanin' Tree and its artists have much more in common with a transaction for the right to publish.

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

## **[C] Some Illustrative Cases**

### **[2] Tangible vs. Intangible Property**

## **COMMENTS**

### **Page 573, add the following**

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

The record in the present case contains the un rebutted affidavit and report of Dr. Fajans, entitled "The Physical Nature of Electricity." He defined electricity as the flow of electrons in a circuit. Dr. Fajans explained: "Electricity is physical and material because, microscopically, it consists of the flow and 'pressure' of a material entity, namely electrons, and macroscopically, it can be sensed (felt, tasted, seen, and heard), measured, weighed, and stored, and is subject to universal laws of nature." Dr. Fajans elaborated as follows: "Without electrons, electricity cannot be transmitted. Though electrons themselves are very small and lightweight, they are one of the basic constituents of matter; common matter like hydrogen or ion consists of electrons, protons, and neutrons in roughly equal number. Recently,

scientists have been able to see electrons, or more precisely, the density of electrons, with devices called Scanning Tunneling Microscopes. . . . There is nothing more physical and material than an electron. Since electricity itself consists of the flow of a material object, electricity is physical and material.” . . .

We now join the several courts that have expressly held in varying contexts that electricity constitutes “tangible personal property.” See, e.g., *Searles Valley Minerals Operations, Inc. v. State Board of Equalization*, [160 Cal.App.4th 514, 521](#), 72 Cal.Rptr.3d 857, 862 (2008); *Narragansett Electric Co. v. Carbone*, [898 A.2d 87, 97-98](#) (R.I.2006); *Davis v. Gulf Power Corp.*, [799 So.2d 298, 300](#) (Fla.Dist.Ct.App.2001); *Curry v. Alabama Power Co.*, [243 Ala. 53, 59-60](#), 8 So.2d 521, 526 (1942).

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

*Query.* How would a “common understanding” approach describe the sale of electricity.

## **§ 29.05 Use Tax and Constitutional Law**

### **[B] Collection Problems—Interstate Issues**

#### **COMMENTS**

#### **Page 579, add the following**

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

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

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

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

Amazon created an “Associates Program,” which allows participants (“Associates”) to maintain links to Amazon.com on their own websites and compensates them by paying “a percentage of the proceeds of the sale.” Amazon also offers incentives to Associates that “directly refer” customers to its Amazon Prime program through website links, paying them a “\$12 bounty” for each new enrollee. Prospective Associates must apply to join the program. Assuming that Amazon accepts the application, the parties enter into an Operating Agreement, which makes clear that the “Relationship of [the] Parties” is that of “independent contractors.” Associates are granted “a revocable, non-exclusive, worldwide, royalty-free license . . . solely for purposes of facilitating referrals from [their sites] to the Amazon Site.” Amazon authorizes Associates to place different types of links from their websites to its own. For example, Associates can set up a “product link,” generally allowing them to “select one or more Products [on Amazon’s site] to list on [their own] site,” a “search box link,” which permits visitors to the Associate’s site to view Amazon merchandise related to their queries, or a “cart link,” which “when clicked will allow visitors [of the Associate’s site] to add products to their shopping cart and/or purchase products via [Amazon’s] 1-Click feature.”

. . . The Operating Agreement [] sets forth that Associates will be paid through a “referral fee” and can elect between the “Classic Fee Structure” (generally 4% of qualifying revenues from sales of products sold through special links) or the “Performance Fee Structure” (a percentage of qualifying revenues set forth in a table that varies with the number of total items shipped). Amazon has hundreds of thousands of Associates. Thousands “of them have provided Amazon with addresses in New York.” Sales to New York customers originating from New York-based Associate referrals constitute less than 1.5% of Amazon’s New York sales. Without disclosing the dollar amount of those sales, Amazon simply acknowledges that its “Associates Program generates more than \$10,000 per year in sales to customers located in New York.”

The court stated:

In *Scripto v. Carson*, [362 U.S. 207](#) (1960) [] the United States Supreme Court held that a State could require tax collection by an out-of-state company that had contracts with 10 in-state residents—deemed “independent contractors”—who solicited orders for products on its behalf. The agreement with the contractors provided that they were to be paid by commission and salespeople sent orders out of state for fulfillment. In contrast, if the only connection with the State is solicitation from out of State—through catalogs, flyers, advertisements in national periodicals or telephone calls—and delivery of merchandise to customers by common carrier or use of mail, there is an insufficient nexus for taxation purposes (see *Quill Corp. v. North Dakota*, [504 U.S. 298](#) (1992)). So long as there is a “substantial nexus” with the taxing State, the taxes that must be collected need not derive from the seller’s in-state activity (*National Geographic Society v. California Board of Equalization*, [430 U.S. 551](#) (1977) [nonprofit society required to collect taxes from California mail-order customers based on maintenance of two offices in California from which advertising was solicited for its monthly magazine]). . . .

Amazon urges that the statute would bring within its ambit “simple advertising by in-state advertisers.” The Commission-Agreement Provision, however, does no such thing. It imposes

a tax-collection obligation on sellers who contractually agree to compensate New York residents for business that they generate and not simply for publicity. Amazon has not come close to refuting the Tax Law's presumed constitutionality and the statute must be upheld.

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

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

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

It does not matter, moreover, that Associates do not solicit New York business at Amazon's direct behest or that Amazon contractually prohibits them from engaging in certain limited specified conduct such as offering its customers money back for Amazon purchases made through Associate links. Amazon chooses to benefit from New York Associates that are free to target New Yorkers and encourage Amazon sales, all the while earning money for Amazon in return for which Amazon pays them commissions. Amazon does not discourage its Associates from reaching out to customers or contributors and pressing Amazon sales.

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

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

The first of the “as-applied” arguments to be addressed is the claim that the statute violates the Commerce Clause. Plaintiffs argue that since their representatives do nothing more than

advertise on New York-based Web sites, the statute cannot be applied in a constitutional manner. Inasmuch as there has been limited, if non-existent, discovery on this issue we are unable to conclude as a matter of law that plaintiffs' in-state representatives are engaged in sufficiently meaningful activity so as to implicate the State's taxing powers, and thus find that they should be given the opportunity to develop a record which establishes, actually, rather than theoretically, whether their in-state representatives are soliciting business or merely advertising on their behalf. Although, as noted above, the advisory memoranda describe a process by which the representatives can certify that they do not solicit, the possibility remains that many of the in-state representatives could certify that they are not soliciting, and, yet, the Department of Taxation and Finance (DTF) could find that the activities in which they are engaged do constitute solicitation. Additionally, it is within the realm of possibility that the DTF could find that purported out-of-state representatives are actually located in-state by virtue of misrepresenting their address. It would also afford plaintiffs the opportunity to establish the bona fides of their other claims, such as whether it is impossible to identify who their in-state representatives are (even though plaintiffs presumably need an address to which to send, inter alia, any commission checks).

We are also unable to determine on this record whether the in-state representatives are engaged in activities which are "significantly associated" with the out-of-state retailer's ability to do business in the state, as addressed in *Tyler Pipe Indus., Inc. v. Washington State Dept. of Revenue*, [483 U.S. 232, 250](#) (1987). In an affidavit from its vice-president, Amazon represents that, in 2007, its sales to New York State residents referred by Associates which provided Amazon with New York addresses upon registration constituted less than 1.5% of its total sales to New York State residents. It argues that this revenue is not "significantly associated" with its ability to do business in New York. Whether plaintiffs can meet their burden on this issue remains to be seen, but we cannot, on this record, make a determination.

## Chapter 33

### CORPORATE INCOME TAX

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#### § 33.03 Preventing Double Taxation

##### [B] Subchapter S Election

###### Page 619, add the following

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

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

##### [1] Taxable

###### Page 625, add the following

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

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

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

that respect.

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

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

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

## Chapter 34

### INTERNATIONAL TAXATION

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#### § 34.01 Taxing the Worldwide Income of “Residents”

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

##### [1] Mechanics; Limitation on FTC

##### [b] Different Baskets

##### Page 637, add the following

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

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

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

*New FTC basket.* Effective for tax years beginning after August 10, 2010, there is a new separate

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

## **[2] More Mechanics**

### **[a] Carryovers**

#### **Page 638, add the following**

Under current law, unused tax credits can be carried back one year and forward ten years.

### **[c] Foreign Losses**

#### **Page 638, add the following**

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

#### **Page 639, add the following**

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

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

## **§ 34.02 Taxing Nonresidents on Income Arising within the Taxing Jurisdiction**

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

#### **[5] Treaties**

#### **[a] Business Income; Permanent Establishment**

##### **Page 643, add the following**

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

### **[B] Nonbusiness Investment Income**

#### **[1] Interest Income**

##### **Page 644, add the following**

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

#### **[2] Dividends**

##### **Page 644, add the following**

The U.S. no longer imposes a tax on dividends paid by a foreign corporation to foreign shareholders when at least 25% of its gross income is U.S. business income. The “branch profits” tax imposed on the foreign corporation’s U.S. business income is considered a sufficient method of taxing such income.

## **§ 34.03 Undertaxing International Income**

### **[B] Intercompany Pricing**

##### **Page 646, add the following**

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

transactions; and methods that allocate the total profits of the controlled entities. The methods based on specific transactions include:

- comparable uncontrolled price method (CUP) (focusing on the price charged by one related entity to another related entity); CUP is favored if the transactions are more or less identical.
- resale price method (RPM) (comparing the gross profit margin earned in sales of products purchased from a related entity with the gross profit margin on sales of products purchased from an unrelated entity); used most often when a related distributor sells finished products without providing significant value added).
- cost plus (comparing gross profit margins in transactions between related and unrelated business); used most often to determine the mark-up when manufacturers sell to related parties.

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

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

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

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

As the text indicates, the uncertainties involved in transfer pricing may lead taxpayers to avoid controversy by seeking advanced pricing agreements (APAs). In an unusual twist, GlaxoSmithKline

argued that the IRS illegally discriminated by denying it an APA when it had entered into an APA with a competitor. In September, 2006, GlaxoSmithKline and the government agreed to the largest settlement ever reached with the IRS (\$3.4 billion) to resolve transfer pricing claims. As part of the settlement, the taxpayer also withdrew its discrimination claim.

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

## **[C] Tax Havens**

### **[2] Typical Tax Haven Income**

#### **[a] Foreign Base Company Sales Income**

#### **Page 647, add the following**

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

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

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

**[c] Foreign Personal Holding Company Income**

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

**Page 649, add the following**

Section 954(c)(6) has been extended through 2011.

**[E] More on Investment Income**

**Page 649, add the following**

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

**Page 649, add the following**

**[F] “Foreign Tax Credit Splitting Event”**

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

(d) Definitions.—For purposes of this section—

(1) Foreign tax credit splitting event.—There is a foreign tax credit splitting event with respect to a foreign income tax if the related income is (or will be) taken into account under this chapter by a covered person.

. . .

(3) Related income.—The term “related income” means, with respect to any portion of any foreign income tax, the income . . . to which such portion of foreign income tax relates.

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

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

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

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

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

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

U.S. corporation.

## Chapter 35

### INTERSTATE TAXATION

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#### § 35.02 Federal Constitutional Limits

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

##### [2] Constitutional Requirements—Connection; Nondiscrimination

##### Pages 654-55, add the following

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

##### [B] Fair Apportionment

##### [1] Income Tax; Unitary Business

##### Page 663, add the following

#### COMMENT ON ADD BACK OF ROYALTY PAYMENTS

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

Before reaching the constitutional issue, the court made two preliminary observations. First, Alabama does not rely on the following technique for dealing with this problem—combining the income of the two corporations as a unitary business. Second, the “subject to tax” exception to the add back rule did not apply. Although North Carolina taxed the royalty as income subject to its apportionment rules, the amount of royalty income subject to apportionment in that state was very

low—0.0019% and 0.0027% of federal taxable income in the case of two North Carolina subsidiaries. The court said that this did not amount to taxation of the royalty payment by North Carolina under Alabama's "subject to tax" exception.

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

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

#### **[C] Discrimination**

##### **[1] Gross Receipts Tax**

##### **Page 669, add the following**

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