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RECENT DEVELOPMENTS IN TAX LAW*

I. CASES FROM THE SUPREME COURT OF THE UNITED STATES 463
  A. Boulware v. United States, *128 S. Ct. 1168 (2008)* 463
  B. EC Term of Years Trust v. United States, *127 S. Ct. 1763 (2007)* 465
  C. Hinck v. United States, *127 S. Ct. 2011 (2007)* 465
  D. Knight v. Commissioner of Internal Revenue, *128 S. Ct. 782 (2008)* 467
  E. The Permanent Mission of India to the United States v. City of New York, *127 S. Ct. 2352 (2007)* 469
II. CASES FROM THE UNITED STATES TAX COURT 471
  A. Adkison v. Commissioner of Internal Revenue, *129 T.C. 97 (2007)* 471
  B. Bakersfield Energy Partners, LP v. Commissioner of Internal Revenue, *128 T.C. 207 (2007)* 472
  C. Baltic v. Commissioner of Internal Revenue, *129 T.C. 178 (2007)* 474
  D. Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner, *128 T.C. 173 (2007)* 475
  E. Domulewicz v. Commissioner of Internal Revenue, *129 T.C. 11 (2007)* 477
  F. Fain v. Commissioner of Internal Revenue, *129 T.C. 89 (2007)* 478
  G. Fears v. Commissioner of Internal Revenue, *129 T.C. 8 (2007)* 480
  H. G-5 Investment Partnership v. Commissioner of Internal Revenue, *128 T.C. 186 (2007)* 480
  I. Giamelli v. Commissioner of Internal Revenue, *129 T.C. 107 (2007)* 481
  J. Jones v. Commissioner of Internal Revenue, *129 T.C. 146 (2007)* 483
  K. Kimberlin v. Commissioner of Internal Revenue, *128 T.C. 163 (2007)* 485

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L. Kligfeld Holdings v. Commissioner of Internal Revenue, *128 T.C. 192 (2007)* 487
M. Kuykendall v. Commissioner of Internal Revenue, *129 T.C. 77 (2007)* 489
N. Leahy v. Commissioner of Internal Revenue, *129 T.C. 71 (2007)* 490
O. Marcus v. Commissioner of Internal Revenue, *129 T.C. 24 (2007).* 492
P. Murphy v. Commissioner of Internal Revenue, *129 T.C. 82 (2007)* 493
Q. Nussdorf v. Commissioner of Internal Revenue, *129 T.C. 30 (2007)* 495
R. Perkins v. Commissioner of Internal Revenue, *129 T.C. 58 (2007)* 496
S. Petrane v. Commissioner of Internal Revenue, *129 T.C. 1 (2007)* 498
T. Proctor v. Commissioner of Internal Revenue, *129 T.C. 92 (2007)* 499
U. PSB Holdings v. Commissioner of Internal Revenue, *129 T.C. 131 (2007)* 501
V. Ratke v. Commissioner of Internal Revenue, *129 T.C. 45 (2007)* 503
W. Severo v. Commissioner of Internal Revenue, *129 T.C. 160 (2007)* 504
X. Weiss v. Commissioner of Internal Revenue, *129 T.C. 175 (2007)* 506

I. CASES FROM THE SUPREME COURT OF THE UNITED STATES

A. Boulware v. United States, *128 S. Ct. 1168 (2008)*

Petitioner, who was charged with criminal tax evasion, introduced evidence that his company had no earnings or profits in the relevant taxable years, causing distributions to be returns of capital not subject to tax and not resulting in a tax deficiency. The district court and the Ninth Circuit barred the claim of return of capital because of a lack of evidence that the diversion of funds was intended to be a return of capital at the time of distribution. The Supreme Court overruled the Ninth Circuit, holding that nothing within §§ 301 or 316 required a showing of intent at the time of distribution that the funds be a return of capital in order to use the claim as a defense to tax evasion.

Boulware was charged with criminal tax evasion and filing a false income tax return in connection with his diversion of funds

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from Hawaiian Isles Enterprises ("HIE"), a closely held corporation of which he was the president, founder, and controlling shareholder. At trial, the prosecution brought evidence that Boulware had received taxable income by diverting payments, writing checks to friends and receiving cash in return, money laundering, etc. In his defense, Boulware introduced evidence that HIE had no earnings and profits in the relevant taxable years, arguing that the distributions of property must have been returns of capital and thus not subject to tax. Because the return of capital was not taxable, Boulware argued that the prosecution could not prove the tax deficiency required to prove the charges against him. The Government moved to bar evidence of this theory, relying on *United States v. Miller*,[1] in which the court held that, in a criminal tax evasion case, a diversion of funds may be deemed a return of capital only after the taxpayer demonstrates that the diversion of funds was intended to be such a return. The Government's motion to bar this evidence was granted, Boulware was found guilty on nine counts and the Ninth Circuit affirmed the conviction.

The Court was asked to determine whether petitioner was required to show intent for a distribution to be deemed a return of capital as a defense in petitioner's tax evasion case. The Court analyzed §§ 301 and 316. The Court stated § 301 provides that a distribution of property that is a dividend must be included in the recipient's gross income and the remaining portions of the distribution are either a nontaxable return of capital or a gain on the sale of stock and thus ordinarily taxable. Section 316 provides a definition for dividends that includes any distribution of property made by a corporation to its shareholders out of its earnings and profits. Reading §§ 301 and 316 together makes the presence of "earnings and profits" the deciding factor in determining the tax consequences of distributions from a corporation to a shareholder.

In analyzing the *Miller* decision, the Court held that, although the decision provided that a defendant may not treat a distribution as a return of capital without evidence of a corresponding contemporaneous intent, nothing in §§ 301 or 316 required a showing of intent. Also, drawing the "earnings and profits" distinction in criminal cases would allow a taxpayer who diverted funds from a corporation in financial difficulty to escape criminal liability.

The Court held that the Government's reliance on *Miller*'s intent requirement was unsupported by the text of §§ 301 and

1. United States v. Miller, 545 F.2d 1204 *9th Cir. 1976).

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316. A criminal defendant accused of criminal tax evasion is not required to produce evidence of the corporation's intent for a distribution to be a return of capital in order to claim such a defense.

B. EC Term of Years Trust v. United States, *127 S. Ct. 1763 (2007)*

Petitioner filed a tax refund action under § 1346 when his wrongful levy suit was barred by the nine-month statute of limitations within § 7426. Section 1346 had a two-year limitation period. The district court dismissed the suit, holding that the exclusive remedy for third-party wrongful levy actions was provided by § 7426.

The IRS levied on the petitioner's bank account containing trust funds. The IRS assumed that the petitioner deposited these funds to evade taxes. The bank responded with a check to the Treasury, and the Trust brought suit almost a year later, claiming a wrongful levy. If the IRS levies on a third party's property to collect taxes owed by another, the third party may bring a wrongful levy action against the United States under 26 U.S.C. § 7426(a)(1), provided that the action is brought within nine months of the date of the levy. After the petitioner's suit was dismissed as barred by the nine-month limitation, the Trust filed a tax refund action under 28 U.S.C. § 1346(a)(1), which has a two-year limitation period. The district court held that § 7426 provided the sole remedy and dismissed the § 1346 refund action.

The Trust argued that the general jurisdiction grant of § 1346 was broad enough to incorporate third parties' wrongful levy claims. However, the Court had consistently held that a precisely drawn, specific remedy would preempt a general one. If the Court allowed third parties' wrongful levy claims under the umbrella of § 1346, these claims could easily skirt the nine-month limitation period of § 7426 against the express limitations tailored by Congress.

The Court held that § 7426 provides the exclusive remedy for third-party wrongful levy actions, thus restricting these claims to the nine-month limitation period specified in the statute.

C. Hinck v. United States, *127 S. Ct. 2011 (2007)*

Petitioner appealed the IRS's denial of his request to abate interest assessed due to delays to the Supreme Court. The Court of Federal Claims and the Federal Circuit had held that the Tax Court was the exclusive forum for judicial review of abatement

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decisions, and that the Tax Court had the authority to refuse to abate petitioner's taxes. The Supreme Court affirmed.

Petitioner John Hinck was a limited partner in Agri-Cal Venture Associates ("ACVA"). Hinck and his wife filed a joint return for the year 1986 reporting losses on his share of ACVA. Over the following years, the IRS examined Hinck's returns for the years 1984-1986 and issued a final notice in 1990 which disallowed tens of millions of dollars of deductions from that time period's returns. ACVA sought administrative review of the decision. In May 1996, the Hincks made an advance remittance of $93,890 in anticipation of any personal deficiency on ACVA's returns. The Hincks and the IRS reached a settlement in March 1999, insofar as the Hincks were involved in ACVA. After adjustments, the IRS imposed an additional liability against the Hincks, totaling approximately $16,400 in tax and $21,670 in interest, which the IRS removed from the Hincks' advance remittance. The Hincks filed a claim with the IRS, requesting that the interest assessed against them from 1989 to 1993 should be abated under § 6404(e)(1), as the delay during this period was due to IRS errors and delays.[2]

The IRS denied the Hincks' § 6404 request, and the Hincks filed suit in the United States Court of Federal Claims seeking review of the IRS's refusal to abate. The court granted the Government's motion to dismiss and the Court of Appeals for the Federal Circuit affirmed.

The Court centered its analysis on the principle of preemption, specifically, that "a precisely drawn detailed statute pre-empts more general remedies."[3] Section 6404(h) provides a forum for adjudication, a class of potential plaintiffs, a statute of limitations, a standard of review, and authorized a specific mode of judicial review. Though § 6404(e)(1) does not explicitly grant the Tax Court exclusive jurisdiction over challenges to the Secretary's abatement decisions, the forum requirements in § 6404(h) apply to § 6404(e)(1) decisions.

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2. Section 6404 of the Internal Revenue Code allows the Secretary of the Treasury to abate any tax liability in certain circumstances. In 1986, Congress amended § 6404 to add subsection (e)(1), which allowed for the Secretary to abate any interest for any period. Following this amendment, federal courts uniformly held that a decision by the Secretary under § 6406(e)(1) was at the Secretary's complete discretion and not subject to judicial review. In 1996, Congress again amended §6404 to add subsection (h), which provides that the Tax Court has jurisdiction over the Secretary's abatement decisions under § 6404.

3. EC Term of Years Trust v. United States, 127 S.Ct. 1763 (2007) (slip op., at 4) (quoting Brown v. GSA, 425 U.S. 820, 834 (1976)).

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The Hincks argued that § 6406(h) provided a standard of review (abuse of discretion) and, by doing so, removed a barrier to judicial review previously recognized by courts. The Court explained that although this standard of review did remove a certain barrier, the other limitations in the same statute could not be ignored.

Similarly, the implied-repeal doctrine did not avail the plaintiffs. The plaintiffs argued that exclusive jurisdiction in the Tax Court impliedly repealed the preexisting jurisdiction of the district courts. However, when Congress passed § 6406(h) in 1996, § 6404(e)(1) already had been interpreted not to provide any right to review in district courts.

The Hincks also argued that the Tax Court's exclusive jurisdiction over § 6404 claims undermined the structure of tax controversy jurisdiction. Generally, the Tax Court hears prepayment challenges to tax liability and post-payment actions are brought in the district courts or Court of Federal Claims. At the time of suit, the Hincks had already paid the interest demanded. This argument, however, was unsuccessful. By granting the Tax Court some jurisdiction over § 6404 claims, Congress had already broken with the traditional scheme. The Court explained that requiring taxpayers to separate § 6404 claims from post-payment actions was no great burden.

Finally, the Hincks contended that Congress did not intend the Tax Court to have exclusive jurisdiction because it would lead to an unreasonable result, namely, that taxpayers with a net worth greater than the statutory amount would be foreclosed from seeking judicial review of § 6404(e)(1) refusals. The Court stated that the net worth limitation in § 6404(h) demonstrated Congress's awareness that wealthier taxpayers were more likely to be able to pay a deficiency before contesting it, thereby avoiding the accrual of interest during the administrative challenge period. In enacting § 6404(h), Congress exercised its authority and narrowed the procedure and jurisdiction for § 6404 claims. The Court held that the Tax Court provides the exclusive forum for judicial review of the Secretary's failure to abate interest.

D. Knight v. Commissioner of Internal Revenue, *128 S. Ct. 782 (2008)*

After the respondent limited the petitioner's deduction for trustee advisory fees to the two percent floor normally applying to individuals, petitioner filed a petition with the Tax Court requesting that deductions be allowed for the full fee amount due

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to the fact that the fees were incurred by a trust. The Tax Court and the Second Circuit held the fees were limited by a two percent floor. The Supreme Court affirmed.

Petitioner Knight was the trustee of the William L. Rudkin Testamentary Trust. Knight hired Warfield Associates, Inc. to provide investment advice regarding the Trust's assets. In 2000, the Trust paid Warfield $22,241 for its services and the Trust reported a total income of $624,816, deducting the full amount paid to Warfield. The Commissioner of Internal Revenue found that these investment advisory fees were subject to the 2% floor, requiring that the Trust could only claim the fees to the extent that the fees exceeded 2% of the Trust's adjusted gross income. Petitioner filed a claim with the Tax Court to allow the deductions. The Tax Court and the Second Circuit both concluded that investment advisory fees were costs of a type that could be incurred if the property were held by an individual rather than in trust, and thus deduction of such fees by a trust was subject to the 2% floor.

Petitioner asked the Court to determine the amount of trustee investment advisory fees that petitioner could deduct from his taxable income. The Court explained that the IRS imposes a tax on "taxable income," applicable to both individuals and trusts. Congress added § 67 to the Internal Revenue Code to allow individuals to subtract certain itemized deductions from taxable income, but only insofar as these deductions exceeded 2% of the adjusted gross income. The same 2% floor applies to trusts. However, costs incurred in the administration of the trust, which would not have been incurred if the trust property were not held by a trust, may be deducted without the 2% restriction. Investment advisory fees for individuals are subject to the 2% floor, but the courts had not previously ruled on the whether the floor also applied to advisory fees incurred by trusts.

The Trustee argued that such advisory fees were unique to trusts and therefore fully deductible. The Tax Court and the Second Circuit both concluded that investment advisory fees were costs of a type that could be incurred if the property were held individually rather than in trust, thus deduction of such fees by a trust is subject to the 2% floor. The Court held that § 67(e) set forth the relevant test: first, the relevant cost must be paid in connection with the administration of the trust and, second, the cost must be one which would not have been incurred if the property were not held in such trust.

The Court rejected the Trustee's argument that advisory fees were exempt from the 2% floor simply because they were incurred in connection with the Trustee's fiduciary duty. There

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was no evidence to indicate that Warfield charged the Trustee for any extra fees in connection with its fiduciary duty, nor treated the Trustee any differently than a private individual.

In determining whether a deduction for the trustee's advisory fees was subject to the 2% floor, the Court held that the appropriate test was whether (1) a particular cost would *not* have been incurred if the property were held by an individual, and (2) the exception applied only to those costs which would be uncommon for an individual to incur. The Court held that seeking investment advice would not be unusual or uncommon for an individual holding the same property as the trust, thus causing deductions for investment fees to be limited by a 2% floor.

E. The Permanent Mission of India to the United States v. City of New York, *127 S. Ct. 2352 (2007)*

Petitioner, a foreign sovereign, refused to pay taxes and tax liens. The City of New York filed suit to establish validity of the liens. In determining whether the Foreign Sovereign Immunities Act of 1976 ("FSIA") provided immunity to a foreign sovereign from a lawsuit to declare the validity of tax liens, the lower court held that the FSIA does not immunize a foreign government from a lawsuit to declare the validity of tax liens on property held by the sovereign for the purpose of providing housing for its employees. The Supreme Court affirmed.

The Permanent Mission of India to the United Nations ("Permanent Mission") is located in a twenty-six story building in New York City owned by the Government of India. Several of the floors of the building house offices for Permanent Mission, but twenty floors are residential units for Permanent Mission employees and their families. All of these employees are Indian citizens who receive housing from Permanent Mission without paying rent.

Similarly, the Ministry for Foreign Affairs of the People's Republic of Mongolia occupies a six-story building in New York City, a building owned by the Mongolian government. Like Permanent Mission, several floors of the building are used as residences for lower-level employers.

Under New York property law, real property owned by a foreign government is exempt from taxation if the property is used exclusively for diplomatic offices or for residential housing for diplomats with the rank of ambassador or minister plenipotentiary to the United Nations. The statute also provides

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that if any portion of the building was not used for allowable purposes, it is subject to taxation.

According to this statute, the City of New York levied taxes against the two agencies for the portions of their buildings used to house lower level employees. The two agencies, however, refused to pay the taxes. The unpaid taxes eventually converted into tax liens held by the City against the two properties. The City filed a state-court suit for declaratory judgments to establish the validity of the liens. The agencies removed the cases to federal court, where they argued that they were immune under the FSIA. The district court ruled for the City, finding that the suit relied on a FSIA exception to immunity, which allows suits where "rights in immovable property situated in the United States are at issue" under 28 U.S.C. § 1605(a)(4).

The Court was asked to determine whether the FSIA provided immunity to a foreign sovereign from a lawsuit to declare the validity of tax liens. The Court explained that § 1605(a)(4) was not limited to cases in which the specific issue was title, ownership, or possession, nor did the statute exclude cases to determine the validity of a lien. The Court further explained that tax liens, according to New York law, were legal rights or interests that a creditor had in another's property. Property ownership was not an inherently sovereign function, and the Court believed Congress did not intend to exclude claims involving property interests.

In determining whether FSIA provided immunity to a foreign sovereign from a lawsuit to declare the validity of tax liens, the Court held that FSIA does not immunize a foreign government from a lawsuit to declare the validity of tax liens on property held by the sovereign for the purpose of providing housing for its employees.

The dissent argued that the purpose of the FSIA was the equitable principle of comity and Congress's intent to abrogate sovereign immunity. They concluded that allowing this suit would open the floodgates of exceptions to sovereign immunity and allow sovereign states to be haled into federal court for any number of civil suits.

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II. CASES FROM THE UNITED STATES TAX COURT

A. Adkison v. Commissioner of Internal Revenue, *129 T.C. 97 (2007)*

Petitioner sought to have his federal income tax deficiencies redetermined and requested relief under I.R.C. § 6015(c). The Tax Court determined that it lacked jurisdiction over the case because the petition was premature within the context of § 6015. Consequently, the court granted respondent's motion to dismiss for lack of jurisdiction.

In 1999, petitioner Adkison filed a joint federal income tax return on behalf of his wife and himself, in which he claimed as a deduction the losses resulting from their involvement in a tax shelter called Bond Linked Issue Premium Structure ("BLIPS") with Shavano Strategic Investment Fund, LLC ("Shavano"). After getting divorced in 2001, petitioner submitted to the IRS an election to participate in a settlement program regarding the BLIPS transaction in order to determine petitioner's 1999 tax liability. Negotiations reached an impasse, however, when petitioner demanded that he be entitled under I.R.C. § 6015(c) to seek an allocation of the tax liability for his 1999 joint tax return.

Petitioner then sought innocent spouse relief from joint and several liability on his 1999 return, and requested that his entire tax liability be allocated in equal shares to him and his ex-spouse. Respondent did not reply to petitioner's request, and instead sent petitioner a joint notice of deficiency in the amount of $5,837,482, which was the total of petitioner's disallowed capital loss, partnership loss, and itemized deductions for 1999. Petitioner subsequently filed a petition with the Tax Court to have his tax liability redetermined under § 6015(c), and asserted that the court has jurisdiction to review his claim because he is "an individual against whom a deficiency has been asserted" as set forth in § 6015(e)(1).

The Tax Court identified the issue as a "jurisdictional dispute . . . requir[ing] an examination of the interrelationship between the Court's jurisdiction to review a claim for relief from joint and several liability on a joint return under section 6015 and the Court's jurisdiction under the unified partnership audit and litigation procedures contained in sections 6221 through 6234."[4] Before analyzing petitioner's claim, the court first explained that § 6015 gave it the authority to hear a taxpayer's

4. *See* Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

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claim for relief from joint and several liability on a joint return, and that the taxpayer may request such relief as an affirmative defense in response to a notice of deficiency. The court also noted that, under § 6231(a)(3), any item accountable for a partnership's taxable year under the provisions of TEFRA subtitle A is treated as a partnership item to the extent such item is appropriately determined at the partnership level, and that, under § 6231(a)(5), any item affected by a partnership item is treated as an affected item.

The Tax Court confirmed, and the parties agreed, that the notice of deficiency was invalid and petitioner was unable to invoke the court's jurisdiction under § 6213(a) because the adjustments reflected in the notice were adjustments to partnership items that were the subject of the partnership-level proceeding in the federal district court. Petitioner, however, contended that he had a valid petition under § 6015(e) and was therefore entitled to relief from joint and several liability on a joint return within the meaning of TEFRA because respondent "asserted" a § 6015(e)(1)(A) deficiency against him. The court disagreed, and held that respondent had not "asserted" a deficiency against petitioner because the underlying partnership-level proceeding was still pending in district court, or in other words, because petitioner's claim had not yet matured into a justiciable claim. The court indicated that a claim for relief from joint and several liability on a joint return under TEFRA is prosecutable only after the completion of the underlying partnership-level proceeding. Accordingly, the court held that it did not have jurisdiction over petitioner's premature claim for relief under § 6015, and dismissed the case.

The Tax Court held that it lacked jurisdiction to hear petitioner's claim for relief from joint and several liability on a joint return under § 6015 because such claim for relief within the context of TEFRA partnership-level proceedings can only be raised upon the completion of the underlying proceeding at the district court level.

B. Bakersfield Energy Partners, LP v. Commissioner of Internal Revenue*, 128 T.C. 207 (2007)*

Respondent determined that Bakersfield Energy Partners had overstated its basis in certain gas reserves of property sold in the year 1998. It issued a Notice of Final Partnership Administrative Adjustment ("FPAA") in 2005 stating this determination. The result was an understatement of partnership income by more than twenty-five percent of the amount stated in

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the return. Respondent argued that the overstatement was an omission of gross income; therefore, the six year statute of limitations that applies to omissions of gross income on a tax return under I.R.C. § 6501(e)(1)(A) should apply. The Tax Court held that the overstatement of the basis was not an omission of gross income for purposes of § 6501(e)(1)(A) and the six year statute of limitations did not apply.

Bakersfield Energy Partners restructured their business, after which they sold their interests in Bakersfield Energy Partners to the new company they had created. Petitioners, after selling their interests, reported the gain from the transaction under the installment method. Respondent sent a Notice of Final Partnership Administrative Adjustment in 2005 alleging that Bakersfield Energy under-reported its gain in 1998 by $16,515,194 when it formed the new business entity. This was the result of overstating its basis. In response, petitioners filed a motion for summary judgment on the grounds that the three-year statute of limitations had run and that the overstatement in basis did not qualify for the six-year statute of limitations for omissions of gross income. Respondent moved for summary judgment on the grounds that the overstatement of basis did constitute an omission of gross income.

The general rule of I.R.C. § 6501 provides that the statute of limitations for any alleged tax deficiencies to be three years from the date the return is filed. However, § 6229 deals specifically with the statute of limitations applicable to partnerships. It provides for the statute of limitations to be extended from three years to six in the case of a "substantial omission of income." The Tax Court stated, "[S]ection 6229 merely supplements section 6501." Because an understatement of basis is not an "omission from gross income," the court looked to the policy behind the statute and court precedent to determine whether the typical three-year statutes of limitations should apply.

The court applied the decision from *Colony, Inc. v. Commissioner* that "the extended period of limitations applies to situations where specific income receipts have been 'left out' in the computation of gross income and not when an understatement of gross income resulted from an overstatement of basis."[5] The policy behind extending the statute of limitations in cases where items are "left off" the tax return is that the Commissioner has a particularly difficult time identifying those items. Thus, if the item is reported, and just under-reported, the Commissioner is at no "disadvantage" in trying to identify a

5. 357 U.S. 28 (1958).

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deficiency in tax. Because Bakersfield Energy Partners reported the disputed items, but merely understated the gain, the Tax Court found that the three-year statute of limitations did apply. Thus, petitioner's motion for summary judgment was granted.

For the purposes of determining whether the six year exception for a substantial omission of gross income applies to the general three year statute of limitations for alleged tax deficiencies, the Tax Court held that the overstatement of basis does not constitute an omission of gross income.

C. Baltic v. Commissioner of Internal Revenue*, 129 T.C. 178 (2007)*

After waiving their opportunity to challenge a tax liability in court, petitioners sought to challenge the underlying liability through an offer-in-compromise based on doubt as to liability ("OIC-DATL") at a collection due process ("CDP") hearing, which the Commissioner rejected. The Tax Court held that an OIC-DATL is a challenge to the "underlying tax liability," and, as such, is barred by I.R.C. § 6330(c)(2)(B).

The IRS notified the petitioners of a deficiency in their 1999 federal income taxes. By 2004, petitioners had failed to challenge the deficiency, and the Commissioner filed a federal tax lien against their property and intent to levy against the property pursuant to §§ 6320 and 6330. The settlement officer presiding over their CDP hearing refused to hear the petitioners' attempt to compromise the amount of their liability through OIC-DATL, because they had already foregone an opportunity to challenge the underlying liability upon receiving their notice of liability five years earlier. Refusing to consider the OIC-DATL, the settlement officer ordered notice of determination that the levy would be postponed, but sustained the lien. The trial court then granted summary judgment in favor of the Commissioner.

On appeal, the petitioners argued that the officer abused her discretion by refusing to consider their OIC-DATL. First, the petitioners contended that, based on a creative reading of § 6330(c)(2)(B), the Code should allow challenges to an underlying liability in all CDP hearings. The court struck down this argument as having no support in the case law or elsewhere in the Code. Second, the petitioners contended that their OIC-DATL was not actually a challenge to the underlying liability, and accordingly, should have been considered at the CDP hearing. However, the one case the petitioners found to support

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this position was distinguishable.[6] In that case, the petitioner had not already had an opportunity, at the time of her CDP hearing, to challenge the amount of her underlying tax liability. The court concluded "that that is an important—indeed decisive—difference."

Leaving no doubt as to such questions in the future, the court "unequivocally" held that "a challenge to the amount of the tax liability made in the form of an OIC-DATL by a taxpayer who has received a notice of deficiency is a challenge to the underlying tax liability."

D. Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007)*

Petitioner had filed a complaint disputing the disallowance of all its deductions for 2002. Respondent alleged that because petitioner engaged in providing medical marijuana to its patients, it was not allowed any deductions under I.R.C. § 280E for "expenditures in connection with the illegal sale of drugs." Petitioner argued that it had two separate businesses: the provision of caregiving services and secondarily, the provision of medical marijuana to its members. Petitioner argued that § 280E did not preclude deductions for those businesses and that his business did not involve "drug trafficking" in a controlled substance.Respondent argued that § 280E precluded petitioner from benefiting from any deductions. The Tax Court found that petitioner did in fact have two distinct businesses and held that the expenses pursuant to the provision of caregiving services were deductible, but those pursuant to the provision of medical marijuana were not.

Petitioner was a California corporation that provided caregiving services and marijuana to its members. It treated patients with AIDS, cancer, multiple sclerosis, and other illnesses. The corporation offered extensive caregiving which included a variety of counseling, activities, and a set amount of marijuana every month. In exchange for these services and the marijuana, the members were required to pay a monthly fee. In 2002, the corporation ceased all activities and filed its Final Return.

Although ordinary and necessary expenses are typically deductible under I.R.C. § 162(a), certain deductions are

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6. Siquieros v. United States, 2004 WL 2011367, 94 A.F.T.R.2d (RIA) 2004-5518, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,244 (W.D. Tex. 2004), *aff'd*, 124 F. App'x 279 (5th Cir. 2005).

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disallowed under other provisions. Section 280E disallows deductions incurred by a business if the business "consists of trafficking in controlled substances." The court began its analysis by reviewing the language of and Congressional intent behind § 280E. The court reviewed the extensive public policy reasons behind disallowing deductions for those involved in the drug trafficking business and held that petitioner was not entitled to deduct those expenses associated with his medical marijuana business. The court reached this conclusion by finding that petitioner's activities of providing medical marijuana to its patients were considered "trafficking."

Although the court disallowed deductions associated with the medical marijuana portion of petitioner's business, it allowed deductions associated with the caregiving portion of petitioner's business. The determination of whether two trades or businesses are separate and apart from each other hinges upon their level of economic interrelationship.[7] The court stated that the Commissioner accepts a taxpayer's statement that its businesses are separate and apart from each other unless it is artificial or unreasonable. The court held that petitioner's two businesses were indeed separate and apart from each other because petitioner provided lengthy and in-depth caregiving services which constituted a business separate and apart from that of providing medical marijuana to its patients. Thus, just because petitioner was not allowed to deduct its expenses relating to the medical marijuana business did not mean it could not deduct its expenses relating to its caregiving business.

The court went on to determine that it was possible to determine an allocation of petitioner's expenses to each of its businesses, and did so. The expenses stemming from the caregiving business of petitioner were thus allowable as deductions.

Section 280E of the Internal Revenue Code precludes a petitioner from deducting expenditures relating to the trafficking of controlled substances. However, the Tax Court held that if it can be shown that there is a separate and distinct business apart from the business that constitutes trafficking, deductions of expenses relating to that separate business are allowed.

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7. Collins v. Commissioner, 34 T.C. 592 (1960).

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E. Domulewicz v. Commissioner of Internal Revenue*, 129 T.C. 11 (2007)*

The Petitioners implemented a tax strategy to offset a capital gain by generating a loss using a partnership, S corporation, and a short sale of U.S. Treasury notes. Based upon these transactions, the Commissioner issued a final partnership administrative adjustment ("FPAA"), claiming, in essence, that the partnership was not entitled to certain deductions it took and that the partnership misstated the basis of the property involved in the transactions. The court found that accuracy-related penalties applied under the circumstances. Also, the Commissioner issued an affected items notice of deficiency because the FPAA was not timely contested by the petitioners. The present case arose when the petitioners challenged the affected items' notice of deficiency. The petitioners moved to dismiss for lack of jurisdiction.

The Tax Court faced two issues in *Domulewicz*. The first issue was whether § 6230(a)(2)(A)(i) of the Code applies the Chapter 63, Subchapter B, deficiency procedures to the disallowance of a claimed pass-through loss from an S corporation. The second issue was whether those deficiency procedures apply to the determination of accuracy-related penalties.

Before addressing those issues, the court discussed its jurisdiction. The court acknowledged that its jurisdiction is limited. However, the court asserted that it will make its own jurisdictional determination when its jurisdiction is challenged. Such a determination will be made even in cases where both parties agree that the court lacks jurisdiction. The court also detailed the process of challenging a partnership's reporting of partnership items.[8]

Addressing the first issue, the court disagreed with the Petitioners' assertion that no partner-level determinations were necessary. The court found that the Commissioner needed to make a variety of partner-level determinations because the only determination made in the FPAA was the determination of which

8. The first step that the Commissioner must take when challenging a partnership's reporting of partnership items is to mail an FPAA to the tax matters partner ("TMP"). The TMP has a limited period of time in which to contest the FPAA, and this is followed by a short period in which other partners may file such a claim. Under the Tax Equity and Fiscal Responsibility Act of 1982, a single unified judicial proceeding will determine the proper treatment of partnership items if contested. After this partnership-level proceeding, computational adjustments will be made for the individual partners. If a partner has an increased tax liability arising from this adjustment, the normal deficiency procedures apply.

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items to include in the assessment. The necessary factual contours of those items remained undetermined.

The petitioners' argument was based on precedent. Relying on *Olson v. United States* and *Bob Hameric Chevrolet, Inc. v. United States*, the petitioners asserted that the tax should have been assessed after they failed to timely contest the FPAA rather than in a deficiency procedure. The court distinguished those cases by the fact that in those cases, the IRS was able to make the adjustments based upon simple income tax returns. The court found that the adjustments would not be possible here, and thus the petitioners erroneously relied upon that precedent. Finally, the court held that the deficiency procedures apply whenever a partner-level determination of a partner's basis is required.

Next, the court addressed the second issue: whether the deficiency procedures apply to the determination of accuracy-related penalties. Interestingly, both the Petitioner and the Respondent agreed that the deficiency procedures did not apply. However, the court stated that adversarial agreement alone is not dispositive of the issue. The court offered a plain reading of language from the Taxpayer Relief Act of 1997 indicating that the deficiency procedures are not to be applied to partnership-item penalties after August 5, 1997. Finding no contrary legislative intent, the Tax Court concluded that the deficiency procedures do not apply to the penalty assessment.

The Tax Court held that the deficiency procedures applied to the deficiency determination made in the affected items notice of deficiency. The Court also held, however, that the deficiency procedures do not apply to partnership-item penalty assessments. Thus, the Tax Court dismissed only the accuracy-related penalties portion of the case for lack of jurisdiction.

F. Fain v. Commissioner of Internal Revenue, *129 T.C. 89 (2007)*

Petitioner Fain filed a petition with the Tax Court after the IRS denied her request for innocent-spouse relief. The Tax Court held that, when a spouse requests innocent-spouse relief, the nonrequesting spouse's right to intervene survives death. Additionally, the Tax Court held that it may order both parties to ascertain the names and addresses of heirs at law of the decedent.

Petitioner Suzanne Vance Fain ("Fain") filed a joint tax return for 1999 with an unpaid amount of $15,000. Neither Fain nor her husband Robert paid the uncollected amount, and

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following their divorce, the Commissioner sought to collect the unpaid tax from Fain. In response to the collection action, Fain filed a request for innocent-spouse relief under I.R.C. § 6015. Her request, however, was denied by the Commissioner in September of 2006, and Fain filed a petition with the Tax Court seeking relief.

Under § 6015(e)(4), the Commissioner is obliged to notify the nonrequesting spouse that the petition was served, so that the nonrequesting spouse has an opportunity to intervene and become a party. In this case, the nonrequesting spouse, Robert, however, had died four years before the petition was filed.

The Tax Court noted that there were two separate issues to be analyzed. The first issue was whether the nonrequesting spouse's right to intervene survives his or her death. The Code and regulations are not clear on this point, but the court held that case law supports the argument that a right to intervene generally passes to a decedent's estate. This provides the decedent's estate an opportunity to protect the decedent's interests because, if the innocent-spouse relief is granted, the decedent's estate becomes the only source of payment for the unpaid tax left behind.

The court further explained that, under § 7701(a)(6), a person who owes another person a fiduciary duty assumes all the rights and privileges pertaining to that person's taxes. The court held that this duty extends to executors and administrators, and noted that the court had granted innocent-spouse relief to executors and administrators in prior cases. In view of this, the Tax Court held that the Code should be construed to allow executors and administrators to intervene and be given an opportunity to oppose relief. Accordingly, the Tax Court held that the nonrequesting spouse's right to intervene in proceedings arising from innocent-spouse relief survives death.

The second issue was what course of action the Commissioner should take when it is not clear whether the decedent has an estate or whether the estate has a personal representative. The Tax Court held that, in such a situation, the court may file an order requiring both parties "to furnish the Tax Court, insofar as ascertainable and to the best of their abilities, the names and addresses of the heirs at law of the decedent, under the law of the jurisdiction wherein the decedent was a resident when his death occurred."

On the issue of whether a nonrequesting spouse's right to intervene in hearings based on a request for innocent-spouse relief survives his or her death, the Tax Court answered in the

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affirmative. Further, when it is unclear whether an estate exists or whether the estate has a personal representative, the Tax Court may file an order requiring both parties "to furnish the Tax Court the names and addresses of the heirs at law of the decedent, under the law of the jurisdiction wherein the decedent was a resident when his death occurred."

G. Fears v. Commissioner of Internal Revenue*, 129 T.C. 8 (2007)*

Mr. Fears filed a petition with the Tax Court regarding a notice of deficiency he had received from the IRS. The Commissioner filed a motion to dismiss for lack of jurisdiction because the notice of deficiency included penalties assessed at the partnership level. The court held that it did not have jurisdiction to proceed because under the Taxpayer Relief Act of 1997, penalties assessed at the partnership level must be defended against in a refund forum.

Petitioner filed a 2000 tax return claiming a loss of over $4 million. The loss stemmed from foreign currency transactions he engaged in through his companies Gateway Investment Partners, GF Gateway Investments LLC, and GF Investors Inc. On his 2001 tax return, petitioner also claimed a similar net operating loss and an overall loss of nearly $3 million. Respondent sent petitioner a notice of deficiency relating to 2001 for disallowance of losses and penalties under I.R.C. § 6662(a) and (h).

With respect to items that require partner-level determinations, under I.R.C. § 6230(a)(2)(A)(i), deficiency proceedings are an appropriate forum for relief. This excludes penalties from adjustments of partnership items. Penalties for partnership items are assessed at the partnership level, and can be challenged by the partner asserting a partner-level defense. This occurs in a refund forum, not in a deficiency proceeding. Thus, because Mr. Fears's notice of deficiency included assessment of penalties at the partnership level, the court lacked jurisdiction to proceed.

H. G-5 Investment Partnership v. Commissioner of Internal Revenue*, 128 T.C. 186 (2007)*

The IRS had issued a final partnership administrative adjustment ("FPAA") in 2006 with respect to G-5 Investment Partnership's 2000 tax return that contained items affecting petitioners' 2002-2004 individual income tax returns. Petitioners filed a motion for judgment on the pleadings, arguing that the

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statute of limitations for the IRS to notice an FPAA for the year 2000 had run. The court held that the 2002-2004 returns were still open to tax assessments with respect to the partnership items from the 2000 return, and thus denied petitioners' motion.

Petitioners Mr. and Mrs. Green were partners in G-5 Investment Partnership and in H. Miles Investments, LLC. They carried forward capital losses from the G-5 partnership in 2000 on their 2002, 2003, and 2004 individual income tax returns. In 2006, the IRS issued an FPAA relating to the partnership's tax liability for the year 2000. Respondent argued that the FPAA was filed within the three-year statute of limitations because the individual petitioners carried forward the losses from the partnerships on their 2004 returns. Thus, the statute ran from 2004, not 2000. Petitioners argued that regardless of the carry-forward, respondent was barred from assessing a tax deficiency through an FPAA for the year 2000 because the three-year statute of limitations had run.

There are two applicable statutes of limitations. Under I.R.C. § 6501(a), any tax must be assessed within three years from the date of the taxpayer's return. Section 6229, added to the Code as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), provides for an extension to the statute of limitations with respect to tax on partnership items. Once the tax liability on partnership items is determined, the Commissioner can assess the tax deficiencies to the individual partners. The determinative point of law was that so long as a year is still open to tax liability and remains open, the Commissioner may examine events occurring in years preceding, even if those particular years were now closed to assessing a tax liability because of the statute of limitations, if those events impact the years still open to tax liability.

Thus, the court held that the statute of limitations did not bar the FPAA because the events occurring in 2000 affected the returns of 2002-2004, which were still open to tax assessments.

I. Giamelli v. Commissioner of Internal Revenue*, 129 T.C. 107 (2007)*

Petitioner filed a petition with the Tax Court after respondent, in a collection action, rejected petitioner's proposal to enter into an installment agreement for the purpose of satisfying petitioner's unpaid tax deficiencies. Soon thereafter, petitioner died in a car accident, and therefore respondent sought to dismiss petitioner's claim. However, petitioner's wife wished to proceed with the case in her capacity as the executrix of

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petitioner's estate in order to show that petitioner's tax due amount should be reduced. The Tax Court ultimately ruled in favor of respondent and dismissed the case because the court found that respondent's appeals officer did not abuse her discretion in rejecting the proposed installment agreement and that the issue of determining petitioner's tax liability was not a properly raised issue in the collection action.

Petitioner Joseph Giamelli and wife Joann Giamelli filed a joint federal income tax return for 2001 in which they reported a tax due of $723,527.01. Because petitioner failed to comply with respondent's subsequent notice and demand to pay, respondent issued a notice of federal tax lien filing. In response, petitioner submitted a request for a collection due process hearing and signed his wife's name without her knowledge. At the hearing, petitioner attempted to enter into an installment agreement to pay $14,300 on a monthly basis toward his 2001 tax liability. Respondent, however, issued to petitioner and his wife the notice of determination sustaining the proposed collection action for the tax liability. Petitioner continued to insist on entering into an installment agreement, and filed a petition for levy action pursuant to § 6320(c), again without his wife's knowledge or permission. As a result, petitioner and respondent agreed to enter into an installment agreement to satisfy petitioner's 2001 tax liability.

However, before executing the formal document, petitioner died in a car accident. Nevertheless, petitioner's wife wished to continue with the petition in her capacity as the executrix of petitioner's estate. She subsequently informed respondent through her counsel that she had no knowledge of the outstanding 2001 tax liability or of the petition filed by petitioner, and that she intended to withdraw from the installment agreement. Petitioner's wife also notified respondent that she intended to reveal petitioner's involvement in fraudulent schemes and bribes not mentioned in the tax return. She claimed that this disclosure would enable her to deduct the alleged illegal payments, thereby reducing the tax liability. Respondent moved to dismiss the case by summary judgment and argued that the proposed collection action should be sustained because petitioner failed to comply with his obligated tax payments.

In analyzing whether to grant respondent's motion for summary judgment, the Tax Court first noted that the court would review the case under an abuse of discretion standard

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because the petitioner did not challenge the validity of the underlying tax liability.[9] Petitioner's estate contended that the underlying tax liability should be redetermined because the estate had a conflict of interest with petitioner, and, in the alternative, that it should be entitled to its own collection review proceeding. The court disagreed with the estate's argument.

The court held that the appeals officer rejected petitioner's proposal for an installment agreement because petitioner failed to comply with his tax obligation, and that, absent evidence to the contrary, the Appeals officer is deemed to have exercised proper discretion in rejecting petitioner's proposal. Because the only issue raised by petitioner in his hearing with the Appeals officer was his request to enter into an installment agreement, the court explained that the estate's argument would essentially require the court to review an issue that was never raised during the collection review proceedings, forbidden under §§ 6320 and 6330, and would undermine the Appeal officer's role if allowed. Accordingly, the court concluded that if an issue was not raised at the time the Appeals officer determined the tax liability, that issue cannot be considered by the court. Consistent with the above reasoning, the court granted respondent's motion for summary judgment.

In analyzing whether petitioner's estate is entitled to challenge petitioner's outstanding tax liability, the Tax Court held that the court does not have jurisdiction to review petitioner's tax liability because it was not properly raised during the collection review proceedings. The court also held that the estate's claim must be dismissed because the estate failed to present evidence suggesting that respondent's Appeals officer abused her discretion in rejecting petitioner's request to enter into an installment agreement.

J. Jones v. Commissioner of Internal Revenue, *129 T.C. 146 (2007)*

Petitioner sought to have his federal income tax deficiencies redetermined after respondent denied petitioner's § 170 deductions stemming from petitioner's donations to a public university. The Tax Court ultimately held that petitioner never had legal ownership of the donated materials, and consequently, petitioner did not affect a valid donative transfer under

9. *See* Davis v. Commissioner, 115 T.C. 35, 39 (2000); Goza v. Commissioner, 114 T.C. 176 (2000).

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Oklahoma law. Accordingly, the Tax Court ruled in favor of respondent and dismissed the case.

Petitioner Leslie Stephen Jones represented Timothy McVeigh against McVeigh's charges relating to the Oklahoma City bombing. Throughout the course of his representation, petitioner received copies of documents and tangible objects from the U.S. Government for investigative purposes. All materials received by petitioner were prepared by government agencies, not by petitioner or anyone working for petitioner.

Nevertheless, after McVeigh's trial, petitioner attempted to donate the materials to the University of Texas at Austin ("University of Texas"). Petitioner executed a "Deed of Gift and Agreement" which was prepared to memorialize the transfer to the Center for American History at the University of Texas, which qualified as a charitable organization under I.R.C. § 170(c). The donated documents were subsequently appraised at $294,877, and petitioner filed his 1997 joint federal income tax return showing a deduction amount of $294,877 as a charitable contribution. Respondent, however, denied petitioner's charitable deduction because the materials donated by petitioner were not personally owned by petitioner.

The issue before the Tax Court is whether petitioner legally owned the materials and whether his donation of the materials constituted a valid gift under § 170. The court first clarified that a gift is not valid for federal tax purposes unless the gift is deemed valid under applicable state law, and that the deductible amount in the case of a valid gift is limited to the donor's basis in the donated property. Under Oklahoma law, the court explained, a gift is valid if three elements are met: (1) donative intent, (2) actual delivery, and (3) abandonment of all ownership and dominion on the part of the donor. By definition, the third prong requires that the donor have legal ownership of the property in question.

In resolving the issue of legal ownership, the court held that the materials donated by petitioner did not satisfy the third prong of the test for whether a gift was valid under Oklahoma law due to the fiduciary capacity in which petitioner obtained the materials in the first place. The court explained that an attorney acts as an agent of his client, and that materials obtained by the attorney in the scope of his client's representation, particularly materials within the client's case file, generally do not qualify as the attorney's personal property. The court also noted that precedent supports the notion that clients are the legal owners of case files when the file has been prepared as part of the services paid for by the client. The court also noted that even in the case

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of divided ownership, the client still holds the property rights in the end product of the attorney's representation. Further, the court noted that the Oklahoma Rules of Professional Conduct, which illustrate the fiduciary relationship between the attorney and client, also support their conclusion that clients maintain all ownership rights in their case files. Although the court hinted that the case would have been more difficult to analyze had the materials constituted petitioner's work product, the court held that further analysis was unnecessary because the materials at issue were not petitioner's work product and did not contain any of his own ideas or thoughts.

Consistent with the above reasoning, the court concluded that petitioner did not have legal ownership of the materials necessary to make a valid gift under Oklahoma law. The court held that petitioner, who was "merely the authorized and incidental custodian" of the materials, had no ownership rights necessary for a valid charitable transfer of the materials. Accordingly, the court held that petitioner's donation of the materials did not qualify as a gift within the meaning of § 170, and that petitioner's charitable deduction must therefore be denied.

In resolving the issue of determining the extent of legal ownership necessary to effect a valid gift under Oklahoma state law, the Tax Court decided that petitioner did not legally own his client's case file donated by petitioner to the University of Texas. Therefore, the court held that petitioner was incapable of making a donative transfer that would enable him to claim a charitable contribution deduction under § 170. Consistent with this analysis, the court ruled in favor of respondent and denied petitioner's request to redetermine his tax deficiencies.

K. Kimberlin v. Commissioner of Internal Revenue*, 128 T.C. 163 (2007)*

Petitioner Kevin Kimberlin contested a notice of deficiency he received regarding warrants that had been exercised pursuant to a settlement and release agreement. Respondent alleged the warrants were received in exchange for performance of services, and thus they should be taxed in 1997 when they were exercised pursuant to I.R.C. § 83. The court held that the warrants should be taxed in 1995, when they were received by petitioners, and not when they were exercised, because they were not in exchange for compensation of services pursuant to § 83.

Kimberlin owned 87 percent of the shares of Spencer Trask & Co. ("Spencer Trask"). In 1993, Spencer Trask entered into an

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exclusive private placement agreement with Ciena Corp. that allowed Spencer Trask Ventures ("Ventures"), a wholly owned subsidiary of Spencer Trask, to be paid in cash and warrants to purchase stock in exchange for their raising money for Ventures. The agreement was modified in 1994, and at the end of that year Ciena broke the agreement with Ventures. Pursuant to a liquidated damages clause in the agreement, Ciena gave Ventures a warrant to buy 150,000 shares of stock at $1 per share. Ventures sought compensatory damages, and in 2005 the parties entered into a settlement and release agreement. In 1997, both Spencer Trask and Kevin Kimberlin Ltd. Partners exercised their warrants to purchase the stock they received through the agreement. The Commissioner issued notices of deficiency to both, contesting the amount of taxable income they realized from exercising the warrants.

The notices of deficiency issued to Mr. Kimberlin and Spencer Trask, and the final partnership administrative adjustment ("FPAA") for Kimberlin Partners were all consolidated for review.

The applicable law allows the warrants to be taxed as income if they were issued in exchange for performance of services.[10] The court found that Ventures was never able to perform the services, and was compensated with the warrants pursuant to the settlement and release agreement. The court rejected all of respondent's characterizations of why the warrants were given to Ventures. Thus, under § 83(a), the warrants were not compensation for services.

Next, the court determined the fair market value of the warrants at the time they were granted to determine the year the warrants would be taxed. The court found respondent's expert, who stated the warrants did not have an ascertainable fair market value, to be unqualified and unreliable. On the other hand, the court found petitioner's expert, who found the value of the warrants to be $0.90 per share, to be credible. Thus, the court held the warrants had an ascertainable fair market value and would be taxed in 1995 because that was the year they were granted. Consequently, the court held the IRS erred in assessing a deficiency in 1997 when the warrants were exercised.

The final issue the court determined was when the warrants should be taxed to Mr. Kimberlin, since he received them as a distribution in 1995 from Spencer Trask. The court again held

10. I.R.C. § 83(a) (2007).

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the warrants would be taxed in 1995, the year in which he received them.

L. Kligfeld Holdings v. Commissioner of Internal Revenue, *128 T.C. 192 (2007)*

Petitioner filed a motion for summary judgment alleging that respondent failed to issue a final partnership administrative adjustment ("FPAA") within the three-year statute of limitations. Respondent contended that so long as one partner's tax liability is affected by the partnership items being addressed in the FPAA, the FPAA can be issued at any time. The court held that the Commissioner could issue an FPAA so long as it affected at least one partner's tax liability.

Respondent challenged the capital gains Kligfeld reported on its 2000 individual income tax return by adjusting items on the 1999 partnership return through an FPAA. The FPAA was issued more than three years after the 1999 return was filed. The court discussed at length the history of the Commissioner's war on tax shelters, specifically those known as "Son-of-BOSS" shelters. The Son-of-BOSS shelters are characterized by the transfer of assets encumbered by significant liabilities to a partnership, with the goal of increasing basis in that partnership. The liabilities are usually obligations to buy securities, and typically are not completely fixed at the time of transfer. This may let the partnership treat the liabilities as uncertain, which may let the partnership ignore them in computing basis. If so, the result is that the partners will have a basis in the partnership so great as to provide for large losses on their individual tax returns.

Marnin Kligfeld was one such taxpayer who utilized the Son-of-BOSS shelter. Kligfeld owned approximately $10 million in Inktomi stock which would have likely resulted in a very large capital gains tax. In an attempt to reduce the capital gains attributable to sale of stock, Kligfeld transferred the stock to a partnership, Holdings 1, which triggered its termination and the creation of another partnership, Holdings 2.[11] When Kligfeld initially contributed the Inktomi stock to Holdings 1, his outside basis in the partnership was equal to his basis in the contributed stock, or approximately $300,000, Likewise, the Inktomi stock continued to have the same inside basis to the partnership as it had before it was contributed-again, approximately $300,000. When Kligfeld contributed the proceeds from the short sale by

11. This was a statutory termination and creation under § 708(b)(1).

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Holdings 1, he arguably increased his outside basis in the partnership in an amount equal to the value of those proceeds, while the inside basis remained the same. Therefore, when Kligfeld transferred his partnership interest to Corporation, he also might have transferred his high basis of $10 million and in return, received shares of Corporation stock with the same high basis.

Holdings 2 eventually sold the stock in 1999 and reported the sale on its 1999 tax return. The capital gain from that sale-now relatively small due to the increase in inside basis-flowed through to the partners, thereby increasing their outside basis. The transactions in which Kligfeld engaged to reduce his capital gains were investigated by the IRS, and a summons was issued to the firm Jenkens & Gilchrist for the names of those engaging in such transactions, of which Kligfeld was one.

The Tax Equity and Fiscal Responsibility Act of 1982 applies to a class of partnerships, and attempts to make all adjustments at the partnership level, which are then communicated to the partners via an FPAA. Section 6229 of the Code limits the length of time the IRS has to make adjustments to partnership items to three years from the date the partnership files the return.

Petitioner argued that the statute of limitations had run when the IRS sent Holdings 2 an FPAA on September 22, 2004. The court clarified that the Kligfeld's individual return for 2000, filed in April, 2001, included the challenged items. Although September, 2004 is more than three years after April, 2001, the court applied a special exception to the three-year statute of limitations. Section 7609 tolls the statute of limitations during the time the IRS is waiting for information to be supplied in response to a summons. Thus, the court found the 2004 FPAA was within the three-year statute of limitations after subtracting the time the IRS waited for a response to the summons.

The Court distinguished a prior case, Rhone-Poulenc,[12] from the present one by noting that in that case, the taxable years in question for the partnership and the partner overlapped. Although the Court appeared to agree somewhat with petitioner that "strange scenarios" might result from the rule, they nonetheless do not rise to the level of "absurdity." The court also discussed, but did not reach, petitioner's due process argument. Thus, the court held that the FPAA was permissible even though the FPAA was issued more than three years after Holdings 2 filed a partnership return.

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12. Rhone-Poulenc Surfactants & Specialties, L.P. v. Comm'r, 114 T.C. 533 (2000).

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M. Kuykendall v. Commissioner of Internal Revenue, *129 T.C. 77 (2007)*

Petitioner brought this case before the court to challenge the underlying tax liability that the respondent had determined that petitioner owed based upon an audit of petitioner's 1999 tax return. Petitioners never received the original notice of deficiency. Petitioner finally received a copy of such notice when only twelve days remained in the statutory period within which they could challenge the determination. Petitioners were denied the opportunity to challenge the underlying tax liability in their § 6330 hearing because they did not challenge it previously during the statutory period. The court addressed the issue of whether the twelve day period was a sufficient time period between the receipt of the notice of deficiency and the lapsing of the statutory period for challenging the determination. Based upon an examination of analogous precedent, the court held that twelve days was an insufficient time period and, thus, Petitioners should have been allowed to challenge the underlying tax liability during their § 6330 hearing.

Prior to the present case, respondent audited petitioner's 1999 tax return. Petitioners failed to respond to the audit report, so respondent issued a notice of deficiency. The notice was sent to petitioner's last known address; however, they had moved and never received it. Petitioners later discovered the problem, and respondent, upon petitioner's request, sent them a copy. When petitioners received the copy, they only had twelve remaining days in the statutory period to petition the court for review. Petitioners did not then dispute the deficiency, and respondent proceeded to send petitioner a notice of intent to levy.

Petitioners then requested a § 6330 hearing to dispute the underlying tax liability. A hearing was held; however, petitioners were not allowed to challenge the underlying tax liability because, respondent asserted, they previously had and failed to exercise their right to petition the court for review. After respondent issued the final notice of determination, petitioners filed their petition with the court to challenge the underlying tax liability. Respondent moved for summary judgment.

The court started its discussion by reviewing, first, the purpose of and rules for summary judgment and, second, the required procedure and rules for levying property. The court stated that § 6330(c)(2)(B) allowed a taxpayer to challenge the underlying tax liability in a hearing if the taxpayer did not receive notice of the deficiency or did not have the opportunity to

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dispute it. Section 301.6330-1(e)(3), Q&A-E2 of the Procedural and Administrative Regulations provided the rule for timely receipt; however, the court stated that it had not yet answered the question of what actual amount of time was required under that regulation. Thus, the central issue in this case was whether the twelve days petitioners had between receiving the copy of the notice of deficiency and the lapsing of their statutory period for challenging that deficiency provided enough time under the regulation.

Two well-established, precedential rules provided the court guidance. First, the court had previously held that thirty days was a sufficient time period. Second, the court had also previously held that seventeen days was an insufficient time period. Applying those two standards, the court held that twelve days was an insufficient time period. Therefore, petitioners were entitled to challenge the existence of the amount of the underlying tax liability during their § 6330 hearing, and the court remanded the case to Respondent's Appeals Office for further proceedings consistent with its opinion.

N. Leahy v. Commissioner of Internal Revenue*, 129 T.C. 71 (2007)*

Petitioners brought this case before the Tax Court in an attempt to get the § 7463(f)(2) small tax case procedures applied to the petitioners' § 6330(d) hearing. The small tax case procedures only apply under certain circumstances, including an unpaid tax amount of less than $50,000. Petitioners' total unpaid tax liability as determined by the Commissioner was more than $50,000. However, petitioners disputed only a portion of the liability in an amount less than $50,000. The court held that the small tax case procedures could not be applied because § 7463(f)(2) requires that the total tax liability as determined by the Commissioner in the notice of determination be less than $50,000, regardless of the amount in dispute.

Prior to *Leahy*, the respondent issued a notice of determination of unpaid taxes to petitioners for the years 1996-2000 in an amount in excess of $50,000. The petitioners requested a § 6330(d) hearing to contest the tax liability, and they requested that the IRS apply the § 7463(f)(2) "small tax case" procedures. The main issue in this case was whether the petitioners' situation qualified for these procedures.

The court examined the relevant law at the outset. Section 7463(f)(2) allows taxpayers to have a hearing conducted under the "small tax case" procedures if it is "an appeal under section

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6230(d)(1)(A) to the Tax Court of a determination in which the unpaid tax does not exceed $50,000." In *Schwartz v. Commissioner*,[13] the court interpreted the language of § 7463(f)(2), stating that the $50,000 limit applied to the amount of the unpaid tax as determined by the Commissioner.

The petitioners argued that the "small tax case" procedures could apply to this case because the amount in dispute was less than $50,000. In their petition, petitioners disputed only a portion of the total underlying liability, and the disputed portion was less than $50,000. Respondent argued that the fact that the amount in disputed was less than $50,000 was irrelevant. Instead, respondent asserted that the relevant amount was the total liability as determined by the Commissioner in the notice of determination. In this case, the total liability as determined by the Commissioner in the notice of determination exceeded $50,000.

The court discussed the difference between § 7463(a), which looks to the amount in dispute, and § 7463(f)(2), which looks to the amount of unpaid tax. The court determined that, in this case § 7463(f)(2) controlled, therefore the "small tax case" procedures would only apply if the amount of unpaid tax was within the $50,000 limitation.

The court then addressed the issue of when the amount of unpaid tax should be calculated. The court found that the relevant date was the date of filing under § 7463(f)(1). However, § 7463(f)(2) required a different rule. The court then began a statutory construction and interpretation of § 7463(f)(2), citing various rules of construction regarding plain meaning, surplusage, and clause modification. Based upon this analysis, the court concluded that the appropriate date for determining the amount of unpaid tax was the date on which the notice of determination was issued. The court, applying this rule to the present case, held that petitioners were not entitled to a hearing under the "small tax case" procedures because the amount of unpaid tax involved in the case was more than $50,000.

In conclusion, the court held that the $50,000 limit of the § 7463(f)(2) small tax case procedures refers to the total unpaid tax on the date of determination. For a section 6330 case, the court held that the date of determination is the date when the Commissioner issues the notice of determination. The court further held that, for the purposes of § 7463(f)(2), the $50,000

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13. 128 T.C. 6 (2007).

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limit referred to the total amount of unpaid tax, not to the amount in dispute.

O. Marcus v. Commissioner of Internal Revenue*, 129 T.C. 24 (2007).*

Petitioners sought to have their federal income tax deficiencies redetermined, arguing that the difference between the adjusted Alternative Minimum Tax ("AMT")[14] basis and the regular tax basis of the stocks purchased through incentive stock options ("ISOs") qualified as an adjustment under § 56(d). The Tax Court disagreed, and held that the difference between the adjusted AMT basis and the regular tax basis of ISO stock does not qualify as a tax adjustment when calculating an after-tax net operating loss in the year the ISO stock is sold.

Petitioner Evan Marcus, who worked for Veritas Software Corp. ("Veritas"), was granted ISOs to buy Veritas common stock. Petitioner exercised the ISOs, and paid $175,841 to acquire shares having a fair market value of $5,922,522. Subsequently, petitioner sold 30,297 shares for $1,688,875. Afterward, when petitioners filed their 2000 federal income tax return, they reported regular taxable income of $315,472, regular tax of $58,427, alternative minimum taxable income ("AMTI")[15] of $5,990,714, adjusted alternative minimum tax of $1,602,874, and total tax of $1,661,301. Petitioners subsequently filed an amended 2000 return, reporting regular taxable income of $261,835, regular tax of $56,039, AMTI of $4,180,033, AMT of $1,099,051 and total tax of $1,155,090. Petitioners claimed a refund from this amended 2000 return, whereby respondent issued a check to petitioners for $575,471. For 2001, petitioners reported regular taxable income of $467,505, regular tax of $105,600, AMTI of negative $3,537,753, AMT of zero, and total tax of zero. Petitioners then amended their 2001 return, reporting regular taxable income of $1,897,072, regular tax of $414,212, AMTI of negative $2,249,867, AMT of zero, and total tax of zero.

In 2005, petitioners received from respondent a notice of deficiency for the taxable years 2000 and 2001. More specifically, respondent denied petitioners' claimed Alternative Tax Net

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14. AMT is defined as "a tax equal to the excess (if any) of— (1) the tentative minimum tax for the taxable year, over (2) the regular tax for the taxable year." I.R.C. § 55(a) (2007).

15. AMTI is defined as "the taxable income of a taxpayer determined with adjustments provided in §§ 56 and 58 and increased by items of tax preference described in § 57." *Id.* § 55(b)(2).

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Operating Loss ("ATNOL")[16] deduction of $1,909,562 in 2000, which resulted in a deficiency of $491,829, and further, issued a deficiency of $178,664 in 2001 by reducing petitioners' minimum tax credit from $414,212 to $213,748.

Petitioners relied on I.R.C. § 56(b)(3) to argue that the difference between the adjusted AMT basis and the regular tax basis of the Veritas shares sold in 2001 is an adjustment to their ATNOL. The Tax Court, however, disagreed and held that the statute does not support petitioner's argument. Specifically, the court interpreted § 172(b)(1)(A) to allow a taxpayer to carry back a Net Operating Loss ("NOL")[17] up to two years preceding the loss, and then forward twenty years after the loss. Further, the court interpreted § 56(a)(4) to allow taxpayers to take an ATNOL deduction instead of an NOL deduction, and explained that ATNOL is calculated by taking into consideration the adjustments to the taxable income under §§ 56 and 58 as well as the preference items under § 57.

The court went on to explain that, under § 421(a), gain is not recognized on the exercise of an ISO, and consequently, the only permitted adjustment under § 56(b)(3) is the gain for AMT purposes when the ISO is exercised and stock is transferred. Further, the statutes only allow an adjustment in the year the ISO was exercised, and do not allow an adjustment in the year of sale.

The Tax Court held that the difference between the adjusted AMT basis and the regular tax basis of stock received by ISO is not a tax adjustment taken into account for the purpose of calculating an ATNOL in the year the stock is sold. According to the court, the sale of petitioners' Veritas stock received through the exercise of ISOs was a sale of a capital asset and thus did not create an ATNOL due to the restrictions under § 172(d).

P. Murphy v. Commissioner of Internal Revenue, *129 T.C. 82 (2007)*

The petitioner and respondent in this case stipulated the facts and the issue by asking the court to consider one question: whether the notice requirement of I.R.C. § 6223(a) was met when a final partnership administrative adjustment ("FPAA") was mailed directly to an indirect partner rather than to the indirect

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16. An ATNOL deduction is defined as "the net operating loss deduction allowable for the taxable year under § 172, subject to exceptions and adjustments under § 56(d)(1)." *Id.* § 56(a)(4).

17. The NOL deduction under § 172 is defined as "the excess of the deductions allowed by this chapter over the gross income, as modified by § 172(d)." *Id.* § 172(c).

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partner's pass-through trust, which, technically, was the actual partner in the partnership named in the FPAA. The court found that § 6233(c)(3) required the Commissioner to notify the indirect partner in this way, and found that the Commissioner had the proper information to do so. Thus, the court held that the notice requirement of § 6223(a) was met.

The petitioner was a young man for whom a trust was established by his uncle and father. The father and son both resided at the same address, which the court referred to in the opinion as the "Oak Brook address." The trust was a general partner in a general partnership, and petitioner's father was the tax matters partner of that same partnership. On the petitioner's tax return, the trust was reported as a grantor trust. On the partnership's tax return, the trust was reported as a general partner.

The IRS sent a notice concerning the audit of the partnership to petitioner and some of the other partners, all of whom were listed on the relevant tax returns as residing at the Oak Brook address, and not to the trust. The FPAA was also mailed to petitioner, instead of the trust, with copies to the other partners, all of whom were reported on the tax returns as residing at the Oak Brook address. Despite these attempts to notify the partners, the FPAAs went unclaimed and uncontested; consequently, the IRS sent a notice of deficiency to petitioner.

Petitioner argued that the notice requirement of § 6223(a) was not met because no FPAA was mailed to the actual partner, the trust. The Commissioner asserted, to the contrary, that the requirements were met because § 6223(c)(3) required the IRS to mail the notice to petitioner, rather than the trust. The statute required such notice if the IRS had sufficient information with which to identify petitioner as an indirect partner and if the intermediate entity was a pass-through partner. The court found that the statute supported the Commissioner's contention: the IRS had a duty to notify the indirect partner rather than the pass-through partner.

The court then examined the sources of the IRS's information about the indirect partner, petitioner. The IRS was aware of petitioner as an indirect partner based upon petitioner's personal income tax return, the partnership's partnership return, and the trust return. The court stated that this information provided the IRS with a sufficient basis for his determination that the petitioner was an indirect partner and therefore entitled to direct notice. Further, based upon the information from the tax returns, the IRS properly mailed such notice to the Oak Brook address.

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Finally, the court disregarded petitioner's argument that the trust was a complex trust and not a pass-through partner. The court found that the petitioner had previously affirmed that the trust was a grantor trust, and a grantor trust was a pass-through partner under the circumstances. Thus, the court held that respondent met the notice requirement of § 6223(a), despite not mailing the notice to the trust as actual partner.

The Court held that the notice requirement of I.R.C. § 6223(a) was met when a FPAA was mailed directly to an indirect partner rather than to the indirect partner's pass-through trust, even though the trust was the actual partner named in the FPAA. The Court further held that § 6223(c)(3) required the IRS to mail the notice to the indirect partner, rather than the indirect partner's pass-through trust.

Q. Nussdorf v. Commissioner of Internal Revenue, *129 T.C. 30 (2007)*

Petitioners contested notices of deficiency issued against them which challenged losses allocated to petitioners by their partnership, which was engaged in the buying and selling of Euro options. The Commissioner moved to dismiss for lack of jurisdiction, arguing that items at issue were partnership items and that the required partnership proceeding had not yet concluded. Petitioner argued, on the contrary, that a partner's basis in contributed Euro options was not a partnership item. Considering the definitions provided by § 6231(a) of the Code, the court held that the items were partnership items, thus the court lacked jurisdiction.

Prior to the present case, petitioners used a partnership to purchase and sell Euro options. These transactions generated gains and losses which were allocated to petitioners as partners. The Commissioner began administrative proceedings related to the partnership and issued a final partnership administrative adjustment ("FPAA"), which essentially asserted that the partnership was a sham. Notices of deficiency followed the FPAA and stated that the partnership existed solely to generate tax losses and that the claimed losses were disallowed.

Petitioners contested those notices of deficiency. They argued that the court had jurisdiction over the determination of the cost basis in the contributed Euro options because they were non-partnership items. Petitioners argued that cost basis was a non-partnership item because an individual partner's cost basis in contributed property does not affect the other partners except insofar as it determines the contributing partner's basis in his or

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her partnership interest. Further, they argued that the partnership does not account on the partnership's books for the partner's cost basis in the contributed property, thus, it was a non-partnership item.

The Commissioner argued that the court had no jurisdiction over the matter in general, asserting that the items involved were partnership or affected items and that the partnership proceeding had not yet been concluded. Regarding the partner's cost basis in the contributed Euro options, the Commissioner argued that the § 6231(a) definitions included such items.

The court's analysis began with a review of the definitions provided by § 6231(a) and a discussion of a partnership's requirement under § 723 to determine the bases of contributed property. Next, the court considered the corresponding regulations and found that the language indicated that such items ought to be determined as partnership items. Based on these findings, the court held that the contributed Euro options' bases were partnership items, thus the court did not have jurisdiction over them. Since the court did not have jurisdiction over the partnership items, the court granted the Commissioner's motion to dismiss.

R. Perkins v. Commissioner of Internal Revenue*, 129 T.C. 58 (2007)*

Petitioner brought this case before the Tax Court to challenge an order to proceed with a levy to collect an unpaid tax liability. Respondent had disallowed claimed capital losses because they exceeded the $3,000 statutory limitation. This disallowance resulted in an increased tax liability for petitioner. Petitioner argued that he was unlawfully denied an opportunity to challenge the underlying tax liability and that his hearing failed to meet the statutory requirements. The court found that the IRS made two possible errors by denying petitioner the opportunity to challenge the underlying tax liability and by allowing an agent to participate in the hearing after having prior involvement in the case. However, the court held that the determination to proceed with the levy was valid because the errors were harmless.

Prior to the case, petitioner filed his income tax return for the year 2000. He claimed $55,778.28 in losses, but he failed to make a § 475(f) election or attach a Schedule D. Upon receiving a request from the IRS, petitioner submitted a Schedule D which reported the $55,778.28 as a net short-term capital loss. The IRS disallowed the loss because it exceeded the $3,000 statutory

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limitation. Petitioner requested a hearing under § 6330, which the IRS initially denied. In 2004, the IRS held a hearing, but petitioner was not allowed to challenge the underlying tax liability. The IRS then proceeded with a levy, but petitioner challenged that action on the ground that he was not allowed the opportunity to challenge the underlying tax liability in the hearing.

The court begun its analysis by stating that § 6330(c)(2)(B) allowed a taxpayer to challenge an underlying tax liability if the taxpayer did not receive proper statutory notice, and found that the IRS provided improper notice. The court found that, therefore, petitioner should have been allowed to make his challenge. The Commissioner argued that petitioner was not allowed to challenge the underlying tax liability because respondent had already considered his request during a review. In response, the court found that the Commissioner's position would result in a perversion of the intent of the "collection due process" provisions because it would allow the IRS to avoid the judicial review required by §§ 6320 and 6330. Thus, the court held that petitioner was denied his right under § 6330(c)(2)(B) to dispute the underlying tax liability.

The court then began a *de novo* review of the underlying tax liability. The petitioner's first argument was that the losses were legitimately claimed because the petitioner was a day-trader. The court examined § 475(f) and discussed the fact that petitioner failed to make a § 475(f) election. Finding that the only evidence supporting the argument was petitioner's own testimony, the court held that petitioner's argument failed and that petitioner was not entitled to the claim the loss.

Petitioner raised two additional arguments that the court found to be unmeritorious. First, petitioner argued that the period of assessment had expired. The court disagreed and stated that the relevant period would not have expired until 2011. Second, petitioner argued that agent who conducted the § 6330 hearing failed to verify that the administrative protocols were met as required by § 6330(c)(1). The court found that petitioner failed to identify any specific error and, based upon the court's own inspection, there was none.

Finally, petitioner argued that the § 6330(b)(3) requirement that the officer conducting the hearing have no prior involvement with the case was not met. The Court stated that this argument, though possibly valid, would have no effect on the ultimate disposition of the case and was harmless error. Thus, the court upheld respondent's levy determination.

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The court determined that the IRS made two possible errors: (1) denying the Petitioner the opportunity to challenge the underling tax liability, and (2) by allowing an agent to participate in the hearing after having prior involvement in the case. However, the court determined that these errors were harmless and it would not be necessary to remand the case. Therefore, the court denied the petitioner's motion.

S. Petrane v. Commissioner of Internal Revenue*, 129 T.C. 1 (2007)*

Petitioner filed a petition with the Tax Court after respondent denied spousal relief from unpaid joint tax liabilities for the years 1996-2000 and 2002. Because the unpaid amounts for each year individually were less than $50,000, petitioner sought to have the case conducted under small tax procedures authorized by I.R.C. § 7463(f)(1). Respondent argued that because the total amount of the unpaid tax liabilities exceeded $50,000, petitioner could not have her case reviewed under the small tax procedures. The Tax Court had to determine what the "amount of relief sought" includes when a party is seeking small tax case status under § 7463(f)(1). The court ruled in favor of the respondent and determined that the petitioner's case was not eligible to be heard under small tax case procedures because the "amount of relief sought" does include the total amount of tax, interest, and penalties for which relief is sought in the petition.

Respondent denied petitioner § 6015(3) spousal relief, and petitioner promptly filed a petition with the Tax Court seeking relief from respondent's determination. In her petition, petitioner requested her case be conducted under small tax case procedures pursuant to § 7463(f)(1) which allows a party to have their case conducted under small tax case procedures if "the amount of relief sought does not exceed $50,000." There are both advantages and disadvantages to small tax case designation. For instance, easier, more flexible rules of procedure and evidence are permitted, but the decisions from small tax court cases cannot be appealed. Respondent argued the total amount of relief sought for the six years was $61,842.23, which petitioner did not dispute. Because the amount of relief sought totaled more than $50,000, respondent moved to remove the small tax case designation. Thus, the questions before the court were how to calculate "amount of relief sought," whether the amount should be calculated for all the years in question or each year in question, and on what date the amount of relief sought should be calculated.

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The court first concluded that the "amount of relief sought" includes "the amount of paid and unpaid tax, interest, and penalties, including accrued but unassessed interest and penalties, for which relief is sought." The basis for the court's decision hinged on the plain language of § 7463(f)(1). The court next held that the "amount of relief sought" would be determined based on the total amount of relief sought for all years, and not for each year. In *Schwartz v. Commissioner*, the court held the amount of relief sought was to be calculated on a total basis, and not per year.[18] The Tax Court then relied on the *Schwartz* interpretation of § 7463(f)(2), a statute which the court stated was similar to § 7463(f)(1), to determine that the total amount during all taxable years should be added together and considered jointly to determine if the amount of relief sought exceeds $50,000. Lastly, the court held that, for purposes of deciding whether a § 6015(e) stand-alone case falls under the small tax case status procedures of § 7463(f)(1), the appropriate date for the amount of relief sought to be determined is the date the petition is filed. Thus, the court granted respondent's motion to remove petitioner's small tax case designation because the total amount of relief she sought for all taxable years in question exceeded $50,000.

In analyzing whether a particular case meets the requirements of § 7463(f)(1) to be designated as a small tax case, the Tax Court held that the total amount of relief sought includes "the amount of paid and unpaid tax, interest and penalties, including accrued but unassessed interest and penalties, for which relief is sought." Additionally, the court held that this amount is to be determined on the total amount of relief sought for all years, not for each year individually. Finally, the court held that the amount is calculated as of the date on which the petition is filed. As a result of this holding, fewer cases will be designated as small tax cases because the total "amount of relief sought" must be less than $50,000.

T. Proctor v. Commissioner of Internal Revenue*, 129 T.C. 92 (2007)*

When respondent denied petitioner's alimony deduction on his federal income tax return, petitioner filed a petition with the Tax Court to have his federal income tax deficiencies redetermined. The Tax Court held that (1) payments made to a former spouse for the children's uninsured medical expenses do

18. 128 T.C. 6, 12 (2007).

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not qualify as alimony and are nondeductible, but (2) military retirement payments to a former spouse do qualify as alimony and are deductible.

Following divorce, petitioner Neil Proctor was required by the divorce decree to pay $675 per month in child support and cover his children's medical and dental insurance. Because petitioner was a member of the U.S. Navy at the time of the divorce, petitioner was also required to pay his ex-spouse 25% of his disposable retirement income under the Uniformed Services Former Spouses' Protection Act ("USFSPA"). Petitioner, however, failed to make the required payments, and his ex-spouse filed a contempt proceeding against him. As a result, the court ordered petitioner to make a series of payments to his ex-spouse totaling $6,074 (of which $2,687 was for his children's uninsured dental expenses). Petitioner subsequently filed a federal income tax return, but respondent disallowed petitioner's alimony deduction of the entire $6,074 paid to his ex-spouse.

The Tax Court was asked to determine how much of the $6,074 payment constituted child support and how much qualified as deductible alimony. With respect to the $2,687 paid for the children's uninsured medical expenses, the Court referred to I.R.C. § 71(c)(1) and (3) to clarify that any amount which was fixed by the divorce decree as payable for the support of children did not qualify as alimony. Accordingly, the Tax Court held that the $2,687 of the $6,074 must be classified as nondeductible child support.

With respect to the $3,768 retirement payments, the court explained that the amount may be deducted as alimony if it meets the requirements laid out in § 71(b)(1)(A)–(D). The court first held that the retirement payments fulfill the requirements of § 71(b)(1)(A) and (C) because petitioner paid the amount pursuant to a divorce decree and petitioner and his ex-spouse resided in separate households at the time of the payments. The Court then analyzed § 71(b)(1)(B), and explained that, absent explicit language of the divorce decree to the contrary, the classification of payment as part of the division of marital property does not preclude the amount from attributed as alimony. Accordingly, the Court held that the retirement payments also satisfy the requirements under § 71(b)(1)(B). Finally, the Court held that the retirement payments also meet the requirements under § 71(b)(1)(D) because the payments were made pursuant to the USFSPA, which provides that the retirement payments will terminate on the day that either petitioner or his ex-spouse dies, whichever date is earlier. Accordingly, the court held that the retirement payments meet

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all the requirements under § 71(b)(1)(A) – (D), and are, therefore, deductible as alimony.

In determining how much of petitioner's $6,074 divorce decree payment to his ex-spouse constituted child support and how much constituted alimony, the Tax Court held that (1) the $2,687 paid for petitioner's children's uninsured medical expenses did not qualify as alimony and was therefore nondeductible, and (2) the $3,768 military retirement payments qualified as deductible alimony and were therefore deductible.

U. PSB Holdings v. Commissioner of Internal Revenue*, 129 T.C. 131 (2007)*

Petitioner, a corporate taxpayer, sought to have federal income tax deficiencies redetermined for the taxable years 1999 to 2002. Petitioner had filed consolidated tax returns with its subsidiaries, but respondent denied petitioner's deduction of tax-exempt interest expenses. Respondent argued that petitioner was required to include respondent's subsidiaries' tax-exempt obligations in calculating its average adjusted basis of tax-exempt obligations. The Tax Court ruled in favor of petitioner, and held that petitioner did not have to include the tax-exempt obligations purchased and owned by its subsidiary in calculating its average adjusted basis for tax-exempt obligations.

Petitioner was the common parent company of a controlled group which included petitioner, petitioner's subsidiary Peoples State Bank ("Peoples"), and Peoples' subsidiary PSB Investments, Inc. ("Investments"). The group members consolidated their assets, liabilities, and incomes for financial purposes. From 1999 to 2002, petitioner filed consolidated federal corporate income tax returns on behalf of its affiliated group, but later filed a petition with the Tax Court to reassess deficiencies upon receiving a notice from respondent of deficiencies in the sum of $145,715. Respondent contended that the deficiencies resulted from Peoples' failure to include the tax-exempt obligations purchased and owned by Investments in the calculation of Peoples' average adjusted basis of tax-exempt obligations. Thus, respondent required Peoples to include in the calculation not only its own tax-exempt obligations, but also Investments' tax-exempt obligations.

The issue before the Tax Court was whether the tax-exempt obligations purchased and owned by Investments must be considered in calculating Peoples' average adjusted basis of tax-exempt obligations under §§ 265(b)(2)(A) and 291(e)(1)(B)(ii)(I). The court first explained that, under the I.R.C., the amount of

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interest expenses that are allocated to tax-exempt interest, which is nondeductible, is found by multiplying the allowable interest expense by a fraction which equals the taxpayer's average adjusted bases of tax exempt obligations (numerator) divided by the average adjusted bases for all assets of the taxpayer (denominator).[19] Though the parties do not dispute that the denominator must include Peoples' adjusted basis in its Investment stock, they disagree on whether to include in the numerator the tax-exempt obligations purchased by Investments (Peoples did not include these obligations in the numerator).

In analyzing the numerator issue, the court applied a plain-meaning interpretive approach to the relevant statutory text, which reads "the taxpayer's average adjusted [bases] . . . of [tax-exempt] obligations" and the "average adjusted bases for all assets of the taxpayer." Under the court's interpretation, the statute did not require Peoples to include tax-exempt obligations purchased and owned by Investments because the statute treated Peoples and Investments as separate taxpayers, despite the fact that Peoples was affiliated in the same group as Investments and filed a consolidated return with Investments. Therefore, the court held that the statute does not require Peoples to take into account the tax-exempt obligations owned by Investments in the calculation of the numerator and interest expense deduction.

Further, the court discarded respondent's reliance on Revenue Ruling 90-44 in which the relevant statutes were interpreted to provide that the numerator for a bank may be calculated with the tax-exempt obligations of its subsidiary. Essentially, because revenue rulings are given a lower degree of judicial deference than regulations, the court declined to adopt its interpretation. Accordingly, the court maintained its conclusion that the tax-exempt obligations purchased and owned by Investments did not need to be included in the calculation of Peoples' average adjusted basis of tax-exempt obligations.

In addressing Petitioner's request to have his federal income tax deficiencies redetermined, the Tax Court ruled in favor of petitioner and held that Peoples was not required by statute to include the tax-exempt obligations purchased and owned by its subsidiary in the calculation of Peoples' average adjusted basis of tax-exempt obligation.

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19. *See* I.R.C. §§ 265(b)(2)(A), 291(e)(1)(B)(ii)(II), 292(e)(1)(B)(ii)(I), 295(b)(2)(B) (2007).

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V. Ratke v. Commissioner of Internal Revenue*, 129 T.C. 45 (2007)*

The Tax Court ruled for petitioners in a case about an alleged tax deficiency and subsequent penalty assessment; however, the decision was vacated on petitioner's motion and petitioners moved for an award of costs and sanctions. In connection with these two motions, petitioners sought discovery of two memoranda generated by IRS attorneys in preparation for the original litigation. In the present case, the Tax Court faced the issue of whether the memoranda were protected by the work-product privilege.

Respondents argued that the memoranda were protected by the work product privilege. First, they argued that the legal opinions contained in the memoranda were absolutely protected under the privilege. Second, they argued that the facts contained in the memoranda, though not absolutely protected, failed to meet the requirements for the exception to the general privilege rule because they were not substantially needed by petitioners. Respondents asserted that the latter were not substantially needed because petitioners were already aware of the facts contained therein.

Petitioners argued that the work-product privilege was not absolute and did not protect these memoranda. First, they argued that they needed access to the memoranda to discover information directly related to the present motions concerning sanctionable misconduct. Second, they argued that Rule 91(a)(1) of the Tax Court Rules of Practice and Procedure required disclosure of the memoranda to facilitate the stipulation of relevant matters to the court. Third, they argued that the memoranda were not work-product related to the post-decision motions, and were, therefore, not protected. Fourth, they argued that respondent waived the work-product privilege by using a redacted version of one of the memoranda in support of a substantive claim, and, because of this waiver, the memoranda were no longer protected by the work-product privilege.

Citing *Hickman v. Taylor* and subsequent binding law, the Tax Court found that the IRS memoranda were work product because they "were prepared as part of respondent's counsels' efforts to 'prepare legal theories and plan strategy' for the instant case." Next, the court found that there was no precedent for petitioner's third argument: that the memoranda were not protected because they were not prepared specifically for the post-decision motions. In fact, the Tax Court found contrary precedent extending the work product privilege protection for

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documents created for a criminal case to related civil litigation. Thus, the court needed to inquire into the exception to the privilege.

The court stated that the work product privilege was qualified. Under the exception, work-product would be discoverable if there was a "substantial need and an inability to otherwise obtain the substantial equivalent without undue hardship." The court conducted an in camera inspection of the memoranda; however, the court concluded that, in this case, there was no substantial need to discover either the fact-based work product or the opinion work product.

Finally, the court considered the waiver argument. The opinion outlined the law regarding the waiver of the work-product privilege and found that waiver generally occurs when the party asserting the privilege makes a "testimonial use" of the work product or attempts to use the work product as a "sword." The court held that respondent only used the work product "in the course of a recital of [a] sequence of events." Thus, there was no waiver of the privilege.

The court held that the memoranda were protected by the work product privilege because they were written in preparation for litigation. The need for the memoranda was not substantial enough to meet the requirements of the exception to the general rule. Finally, respondent did not waive the protection because their use of the memoranda was only to describe a sequence of events. The court held that the petitioners request to discover the memoranda would be denied.

W. Severo v. Commissioner of Internal Revenue*, 129 T.C. 160 (2007)*

Joint taxpayers Michael and Georgina Severo sought relief from an adverse ruling on a notice of Federal Tax Lien filing ("NFTL") by the IRS, which required them to pay a 1990 tax debt notwithstanding their Chapter 7 bankruptcy. Petitioners claimed that the bankruptcy order had discharged their tax liability, and that the statute of limitations barred the Commissioner's efforts to collect. In granting the Commissioner's motion for summary judgment, the Tax Court held, *inter alia*, that Petitioners' 1998 debt was not discharged in bankruptcy.

Petitioners filed a 1990 tax return late and failed to pay $63,499 in taxes due. Petitioners subsequently made substantial payments against this amount, but still owed a large portion of the debt. In 1994, the couple filed for bankruptcy, and several of their debts were discharged through Chapter 7 bankruptcy in

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1998. In 2004, the Commissioner levied against the petitioners' California income tax refund, without appeal from the petitioners. In 2005, the Commissioner again attempted to levy against property of the petitioners, and filed a NFTL. While petitioners could not appeal the second levy, they appealed the NFTL with the IRS, claiming that their 1998 bankruptcy had discharged their remaining 1990 tax debt. The IRS held a § 6320 hearing on the NFTL, and notified petitioners of its adverse ruling on March 3, 2006. The Tax Court then dismissed petitioners' claims relating to the levy for lack of jurisdiction, and ruled only on the NFTL.

Petitioners had petitioned for bankruptcy on September 28, 1994, less than three years after filing their October 15, 1991 tax return giving rise to their 1990 tax liability at issue. Because their tax liability fell within the three-year "look-back" period, it qualified as a priority debt under Bankruptcy Code § 507(a)(7)(a)(i), and was therefore exempt from Chapter 7 discharge under § 523. Petitioners' reliance on *In re Doss*[20] was misplaced, as the bankruptcy court in that case had treated factually similar years exactly as the court did here, and in both cases refused to discharge a tax debt that accrued less than three years prior to the date of bankruptcy petition.

The Court also rejected petitioners' contention that the statute of limitations on their 1990 tax liability had run before the Commissioner's 2005 NFTL. Under § 6502, the period of limitation for collecting federal income taxes ends ten years after the date taxes are assessed. The question presented was which I.R.C. section would control suspension of the limitations period in a bankruptcy case. Section 6503(b) would suspend limitations "for the period the assets of the taxpayer are in the control or custody of the court," while § 6503(h)(2) would suspend the period for the time "during which the Secretary is prohibited by reason of [a bankruptcy] case from making the assessment or from collecting," plus six months thereafter.

Relying on *McAuley v. United States*,[21] petitioners urged the court to apply § 6503(b), which would have suspended the ten-year collections period for only about two years (from the date of bankruptcy petition, September 15, 1994, until November 9, 1996, one year after the meeting of creditors). However, the court followed the analysis of *Richmond v. United States*[22] in deeming § 6503(h) to be more appropriate in this situation,

20. 42 Bankr. 749 (Bankr. E.D. Ark. 1984).

21. 525 F.2d 1108, 1114 (9th Cir. 1975).

22. 172 F.3d 1099 (9th Cir. 1999).

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particularly because the *Richmond* court had based its decision on the current version of the Bankruptcy Code. Accordingly, the limitations period began on October 15, 1991 and was suspended for almost four years from September 1994, the date of petition, until September 1998, six months after the date of discharge. Thus, the limitations period did not expire until after the September 2005 date on which the Commissioner filed a NFTL. The court rejected petitioners' claim that their bankruptcy was a "no-asset" case, dismissing the petitioner's evidence, and did not resolve the issue on the merits.

The Tax Court held, "[b]ecause section 6503(b) refers only generally to a court proceeding and because section 6503(h)(2) refers specifically to a bankruptcy proceeding, we conclude that section 6503(h)(2) is applicable to a situation involving bankruptcy and is not limited by section 6503(b)."

X. Weiss v. Commissioner of Internal Revenue*, 129 T.C. 175 (2007)*

Petitioners failed to include $24,376 of qualified dividends in their taxable income on their 2005 individual income tax return, and instead calculated taxes on the qualified dividends separately at a rate of 15%. The IRS called this (along with other irregularities) a "math error," and determined that the petitioners had a deficiency of $6,073. Petitioners requested that the Tax Court reassess the deficiency.

The court determined that, because AMT income includes gross income, which includes all "dividends," the Code does not differentiate between qualified and ordinary dividends. Thus, all dividends are included in AMTI.[23] Notwithstanding the somewhat special treatment of qualified dividends under the AMT and petitioners' position to the contrary, "qualified dividends may not be excluded altogether."

The court stated "[w]hatever ambiguity might be found in Form 1040 and its instructions in this regard, however, cannot affect the operation of the tax statutes or petitioners' obligations thereunder." Thus, the Tax Court held that qualified dividends may not be disregarded in computing the AMT.

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23. *See* I.R.C. §§ 55(b)(2), 61(a)(7), 63(a).