



2014 YEAR-END TAX UPDATE

DECEMBER, 2014

Dennis L. Cohen

Cozen O'Connor

1900 Market Street, 3rd Fl.

Philadelphia, PA 19103

dcohen@cozen.com | 215.665.4154

SOME THOUGHTS FOR THE COMING YEAR AND BEYOND ON TAXES, OUR FUTURE AND LIFE ITS OWN SELF

▶ *“We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.”*

- Winston Churchill

▶ *“Day in and day out, your tax accountant can make or lose you more money than any single person in your life, with the possible exception of your kids.”*

- Harvey Mackay

▶ *“What's the difference between a taxidermist and a tax collector? The taxidermist takes only your skin.”*

- Mark Twain

▶ *“The income tax has made more liars out of the American people than golf has.”*

- Will Rogers

▶ *“Father Christmas, give us some money
Don't mess around with those silly toys
We'll beat you up if you don't hand it over
We want your bread so don't make us annoyed
Give all the toys to the little rich boys.”*

- The Kinks – “Father Christmas”¹

¹ Okay, so maybe “Father Christmas” doesn't have much to do with taxes, but it does involve money (which is somewhat similar), and I love The Kinks. Anyway, it's my second favorite Christmas song, after “Wham's “Last Christmas,” and George and Andrew, what the hell ever happened to you guys?

I. A LOOK BACK AT 2014 TAX MATTERS

A. Some Random Observations

1. This year's update is brought to you by the letter "I," as in "inversions."
2. Tired of waiting for Congress to address what they view as an increasingly harsh and unfair corporate income tax regime by such simple expedients as cutting tax rates in half, adopting a territorial system of taxation, or imposing a significantly reduced levy on the repatriation of funds held abroad, corporations engaged in self-help activities by partnering up with non-U.S. corporations that, though smaller and less important, became their foreign parent.
 - a. As Steven Colbert put it, when explaining an inversion to his audience, "It's like me adopting an African child, then claiming myself as his dependent."
 - b. If your author could pick a foreign parent, he'd choose Sophia Loren.
3. Treasury and IRS, in turn, tired of waiting for Congress to address the increasing leakage² of taxable revenue from inversions and other games people play (e.g., MLP's and REITs, of which more later), announced new rules intended to make inversions less attractive and more difficult to accomplish.
 - a. Those rules left a number of merger arbitrage hedge funds wrong-footed when proposed inversion deals got scuttled, leading to the delicious irony of an anti-tax abuse initiative giving rise to larger capital losses – and, hence, fewer taxes to collect from the investors in those funds – a development which left no one particularly happy.
4. Other than the new inversion rules, there was little in the way of important tax regulation or legislation in 2014, not unsurprising in a world in which your Congress made the Maytag repairman seem like the hardest working man in America.
5. Even the proposed "extenders" legislation, which is designed, as the name suggests, to "extend" those numerous politically popular tax provisions that expired on December 31, 2013, into 2014 and, perhaps, beyond had not, at the time of these scribbles, been enacted. (More on that later as well.)
 - a. Which brings us to a mystery question of life of whether a "do nothing" Congress can do something when it becomes a "lame duck" Congress or, rather, whether it will be a "do nothing lame duck" Congress. Stay tuned, fellow travelers.
6. Most of us had managed to forget the compromise that ended 2013's "fiscal cliff" scare until it came time to prepare our 2013 income tax returns, with all of their higher rates, resurrected phase-outs, and new Medicare and net investment income taxes, all of which conspired to make tax season this year so challenging to taxpayers and practitioners alike.
 - a. Those increases remain in effect for 2014, but those provisions of the Affordable Care Act that took effect in 2014 will keep practitioners – and IRS – from getting bored.

² Leakage, tax or otherwise is, of course, a rather sensitive subject and so will be treated with discretion throughout these materials.

7. As always, there were the scattered calls for major tax reform but, as usual, they fell on deaf (and dumb) ears. Expect similar calls from the new Congress and similar “results.”
8. Although there was little important tax legislation in 2014, there were, as usual, numerous tax-related decisions, rulings and other developments throughout the year, and our continuing mission is to summarize herein some of those items that I found to be most important, unexpected or just plain stupid. As always, I alone (and neither my law firm nor my capable and serious colleagues in our Tax Group) am responsible or to blame for the content of these materials, which I hope you find useful and entertaining.

II. SELECTED TAX DEVELOPMENTS

A. By the Numbers.

1. Despite assertions to the contrary by the Federal Reserve (whose governors, apparently, never send their kids to college, purchase Eagles and Flyers tickets,³ or give a rat's behind about their parents who live on fixed incomes and safely invest their meager savings for 15 basis points), there was some price inflation in 2014, and so the IRS has announced 2015 inflation adjustments to some 40 or so tax provisions.
2. Among those inflation adjusted figures:
 - a. The standard deduction for joint filers increases to \$12,600 (from \$12,400), and the personal exemption rises \$50 to \$4,000. The phase out of the personal exemption deduction for married taxpayers begins at \$309,900 and is eliminated entirely at \$432,400. Phase outs of any kind again support my wife's opinion that I'm good for nothing (or hardly anything).
 - b. The estate tax exclusion for 2015 was raised from \$5,340,000 to \$5,430,000, although the gift tax annual exclusion remains \$14,000.
 - c. The “annual additions” limit for defined contribution plans increases by \$1,000 to \$53,000. The exclusion for elective deferrals to certain qualified plans (e.g., § 401(k) plans) goes up \$500 to \$18,000, as does the dollar limit for “catch-up” contributions by taxpayers age 50 or older, which becomes \$6,000 for 2015.
 - d. The 2015 Social Security wage base rises \$1,500 to \$118,500, or about 1.3 percent (the increase in average total wages). Social Security benefits (which are adjusted using a different index) will go up 1.7 percent, which should be adequate if your sustenance consists of “Happy Meals” and your entertainment, 76ers tickets.⁴

³ No such problem exists for tickets to see your “10-9-8-76ers,” the price of which is as deflated as the team's fans – all three of us.

⁴ I don't mean to sound as if I'm picking on the Sixers. I actually love the team. Indeed, I took clients to the home opener and we had a great time, which was largely attributable to the new 24-ounce beer pour that you can get at the game for a mere \$13.25.

3. In her article of April 12, 2014, Laura Saunders, the tax columnist for *The Wall Street Journal*, provided a fascinating look at where your tax dollars go. As one might expect, about 70¢ of every tax dollar gets allocated to defense, Social Security and health care. 0.004 cents goes to Congressional salaries, demonstrating once again how much waste there is in government. (In the interest of full disclosure, the last observation was that of your faithful correspondent and not of Ms. Saunders.)
 - a. 2014's Tax Freedom Day, i.e., the date that reflects the estimate of how long it takes "we the people" collectively to pay our tax bill, was April 21. State Tax Freedom Day for New Jersey was May 9, proving once again that the Garden State is an expensive place in which to abide. But, as the wag said, "someone has to live there."
4. Budget cuts caused IRS's individual audit rate to dip to 0.96 percent in 2013, the lowest it's been in eight years.
 - a. Although 10.85 percent of individual returns showing income of \$1 million or more were examined, that figure was down from the 12.14 percent rate of 2012. Only 2.7 percent of the returns of individuals with incomes between \$200,000 and \$1,000,000 were audited.
 - b. The rate of examination of entity returns (other than those of large corporations) also declined.
 - c. And the Transactional Records Access Clearinghouse, a research organization affiliated with Syracuse University, concluded in a report earlier this year that the total number of tax-related lawsuits filed in the United States declined 32 percent from 2009's level. The United States was the plaintiff in about three-quarters of those lawsuits, and much of the litigation was to enforce an IRS summons or a federal tax lien.
5. The Spring 2014 edition of the Statistics of Income, dealing with 2011 federal income tax statistics, reported that about 145 million income tax returns were filed for 2011 and that 63 percent of those returns (about 92 million) reported income tax of greater than zero, the third lowest percentage in 25 years. Unsurprisingly, the lowest such percentage was 58.3 percent in 2009.
 - a. The aggregate income tax shown on the "taxable" 2011 returns was \$1.05 trillion, about a 10 percent increase from 2010. The average tax rate for such returns was 13.6 percent.
 - b. 4.7 million returns for 2011 reported AGI in excess of \$200,000.
6. In 2013, the IRS paid whistle-blowers a total of \$53 million with an average award of \$435,000. Tips from whistle-blowers were said to have led to the collection of \$367 million, a nice return on the money.
7. A KPMG study on international tax and business costs for new businesses (including income, property, sales, local business and other taxes) revealed that the tax burden for new Canadian businesses was about 46 percent less than that for new U.S. corporations. New French corporations, on the other hand, pay 63 percent more in taxes than new U.S. businesses. (C'est incroyable!)

- a. Looking at major U.S. cities, the lowest tax costs were in Atlanta and Cincinnati. New York had the highest tax costs and second highest total business costs, so if you can make it there, you'll make it anywhere. (San Francisco had the highest total business cost.)
 - b. The City of Brotherly Love ranked 23rd (of 31) major U.S. cities in total business costs – a good ranking – but had the sixth highest tax costs, which is not so good.
8. Bloomberg reported that U.S.-based companies added \$208 billion in offshore profits in 2013, based on a review of securities filings. U.S. multinational companies have accumulated nearly \$2 trillion outside the United States.
 - a. In 2013, Apple, Microsoft and IBM alone combined to add \$37.5 billion to that stockpile.
9. For those of you interested in “The Story State of Corporate Taxes,” read the March 2014 report of the same name by Citizens for Tax Justice. The report contains many fascinating nuggets and interesting analyses from an examination of those Fortune 500 companies that had profits in each of the years 2008-2012. Among those nuggets is that 26 of those companies paid no federal income tax in that five-year period, including Boeing, Priceline.com and Verizon, and 111 of them paid no federal income tax in at least one of those years.
10. In the recent election, voters in Oregon approved the sale of marijuana for recreational use (becoming the third state to do so), and DC voters approved an initiative allowing residents to grow pot indoors. Sixty percent of Massachusetts voters rejected an attempt to repeal its 2011 law that permitted casino gaming. On the other hand, Arkansas voters rejected a constitutional amendment that would allow alcohol sales in all counties (bathtub moonshine, however, is likely to be unaffected), and Berkeley, Calif., passed a tax on soda and other sugary drinks. California dreaming, my ass. No further commentary on the foregoing is needed.

B. Employment Tax Matters.

1. In CCA 201436049, chief counsel determined that “limited partners” in an investment management firm organized as an LLC were subject to self-employment tax on their entire distributive shares of the company’s income. The LLC served as general partner for a family of limited partnership investment funds, and the LLC and its members provided management services to the funds. The chief counsel’s advice memorandum, relying on Rev. Rul. 69-184, rejected the company’s attempt to avoid self-employment income treatment on the members’ distributive shares by issuing a W-2 to the members for a portion of their distributions and then claiming that this amount represented reasonable compensation for their services. Instead, the “W-2 portion” was treated as self-employment income as well.
 - a. Note that the 1997 proposed regulations defining “limited partner” have never been issued as final regulations.

2. In *Potts v. U.S.*, a district court in California found that a partner of a general partnership was secondarily liable for the partnership's unpaid employment taxes. Once an assessment is made against a general partnership, the IRS is not required to separately assess the partners (e.g., under § 6672) in order to make them liable for the unpaid taxes; they are secondarily liable for the taxes by operation of state law.
 - a. The case is likely quickly to become a relic. With the advent of LLC's, finding a general partnership is like finding Bigfoot.
3. For many years now, we have discussed in these materials and our seminars the question of whether severance payments made to laid-off employees are subject to FICA. This issue was posed in *U.S. v. Quality Stores*, a case that took a journey to the Supreme Court that was worthy in length to Odysseus' voyage from Troy to home, but whose ending was less happy, for in March of this year, the Supreme Court held unanimously that such payments are indeed "wages" subject to FICA.
4. Speaking of FICA, the Court of Federal Clams earlier this year in the *Balestra* case, upheld the validity of the regulations to § 3121(v), with the effect that Mr. Balestra was subject to FICA tax on wages (actually, deferred compensation benefits) that he will never receive. Balestra, who retired from employment with United Airline in 2004, was entitled to non-qualified deferred compensation benefits under a "non-account balance plan" (essentially, a defined benefit plan formula). Section 3121(v) and its regulations require that the full present value of the benefits be included in the FICA wage base as of the later of when the services are performed which entitle the taxpayer to the benefit, or when there is no substantial risk of forfeiture of the right to the benefits.
 - a. United Airlines had filed for bankruptcy in 2002 and, in 2010, made the final payments required under its bankruptcy plan; thus, Mr. Balestra will never receive all of the benefits that were included in his FICA wage base in 2004.
 - b. The court rejected a number of interesting arguments advanced by the taxpayer, finding that Congress chose to adopt a § 83 approach in § 3121(v), rather than normal "accrual" concepts. Under typical income tax accounting rules, a taxpayer needn't accrue in income an amount that is likely never to be paid.
5. Worker classification (or, perhaps more accurately, worker misclassification) enforcement cases have been brought with increasing frequency in recent years, but practitioners have lately been reporting an increase in the number of such cases in which the IRS is bringing criminal charges against business owners. Some attorneys are particularly concerned that states might pile on citing, for example, New York's Fair Play Act.

C. Accounting Matters and the Profession.

1. IRS Commissioner Koskinen predicted at an IRPAC meeting that the 2015 filing season "will be one of the most complicated, if not the most challenging, filing seasons in a long time, if not forever." He cited new responsibilities under the Affordable Care Act, uncertainty regarding proposed extenders legislation and the expired provisions such legislation is intended to address, and a reduced IRS budget as some of the causes.
2. A Technical Corrections Bill is also awaiting Congressional action. Some of the technical corrections relate to such long-ago legislation as the American Jobs Creation Act of 2004.

3. And, as for those expired tax breaks, the “Expiring Provisions Improvement Reform and Efficiency (EXPIRE) Act” (HR 3474), which would extend some 55 provisions that sunsetted on 12/31/13, is awaiting Senate action. Now that the midterm elections are over, practitioners are once again in need of low comedy, Washington, D.C., style.
4. The Treasury Inspector General for Tax Administration (“TIGTA”) criticized IRS this summer for the Agency’s tardiness in processing taxpayer complaints against return preparers. According to TIGTA, as of September, 2013, 83 percent of such complaints (including preparer fraud) dating to 2012 were still being processed or hadn’t been addressed. If you, dear reader, were similarly slow in disciplining your children, they would all grow up to be gangsters, thugs or politicians.
5. Assailed on all fronts, IRS continues to struggle with identity-theft tax fraud. IRS estimates that for the 2013 filing season, it paid out more than \$5 billion in erroneous refunds.
 - a. But this wound is partly self-inflicted. The simple expedient of not processing refund claims until Forms W-2 were received would help reduce the scope of this problem, as would better computer programming to detect obvious fraudulent filing locations.
6. IRS reminds taxpayers and practitioners alike that it does **not** make unsolicited calls demanding more taxes or alerting taxpayers that they are due refunds; the Service first contacts taxpayers by mail. These calls are scams.
7. New York state, in July, announced that it had suspended 40 tax preparers for failing to file their own tax returns. New York has about 40,000 paid preparers, which is more than the remaining number of NY Jets fans.
 - a. Some New York residents, who believe the state doth protest too much, prefer to take their custom to return preparers who are themselves non-filers in the perhaps not unreasonable belief that those practitioners will produce the largest refunds for their clients.
8. Shockingly, IRS is not as vigorous as New York in dealing with crooked return preparers. IRS expects to come down hard on return preparers who divert part or all of client refunds, *but not until next year!* Some preparers use Form 8888 (used to allocate income tax refunds to more than one account) to have their fee direct deposited into their own accounts from clients’ refunds, and those practitioners will be the subject of next year’s crackdown.
 - a. The foregoing item dealing with Form 8888 is **NOT** a practice pointer; it is a violation of federal law. If you are caught, do not tell the U.S. Attorney that you learned of this technique in Mr. Cohen’s Year-End Update Seminar.
9. In fairness, the IRS by and large does a pretty good job of administering the tax laws and the tax collection system, despite being charged each year by Congress with more impossible tasks to perform and with fewer dollars to carry out these tasks. And in my experience, most revenue agents and revenue officers are dedicated employees who try to do the right thing. (But more later to the contrary.) But the IRS certainly could use help in the PR department. Perhaps the commissioner could tout the agency’s progress in a fair and balanced presentation on Fox News.

10. Pennsylvania's ban on same-sex marriage was struck down in May as unconstitutional. As a result, gay married couples in Pennsylvania can now file joint returns. Other courts that have considered the issue have come to the same conclusion.
 - a. In November, however, a federal appeals court broke ranks and upheld state laws that prohibit same-sex marriage, setting up a possible Supreme Court decision on whether a ban on same-sex marriage violates the U.S. Constitution, a case that pundits believe the Court would have preferred not to have had to hear.
11. In CCA 201430013, the IRS held that a corporation and its wholly-owned LLC (which had formerly been a subsidiary) conducted separate trades or businesses and, accordingly, under § 446(d) could use different accounting methods. Even though the LLC was tax disregarded, it had a separate and distinct trade or business.
12. After his mother's death, Mr. Smith donated the furniture from her house, as well as clothing and electronic equipment of his own, to the AMVETS, a § 501(c)(3) organization. Mr. Smith's \$27,000 contribution deduction was disallowed for failure to satisfy the substantiation requirements of §170(f) relating to gifts of property in excess of \$500 and of \$5,000. Although the judge was sympathetic and had no doubt that the claimed contributions were made, the Tax Court was bound by the contribution substantiation tests. *Smith v. Commissioner*. Practitioners must be mindful of the special rules dealing with in-kind contributions.
13. The Tax Court ruled in *Alvan Bobrow v. Commissioner* that the code's limitation of one rollover every 12 months applies on an aggregate basis to all of a taxpayer's IRA's, rather than on an IRA-by-IRA basis. Even though proposed regulations and IRS Publication 590 say the limitation is applied on an IRA-by-IRA basis, Judge Nega imposed the 20 percent accuracy-related penalty, concluding that IRS publications are not substantial authority for return positions and that "taxpayers rely on IRS guidance at their own peril." Really? Come on, man!
 - a. A request for reconsideration was filed, but the case was settled before that request was heard.
 - b. As Willie Nelson might say, "Don't You Think That's a Little Unfair," but to your author, the case is an outrage. (I say that knowing full well that Mr. Bobrow was the head of Mayer Brown LLP's tax department and, as such, presumably a tax expert.) For starters, why did the IRS seek the 20 percent accuracy-related penalty at all when what was inaccurate was the IRS's own publication (which Bobrow, at his peril, followed). Hell, I'm inclined to take back the nice things I said in Paragraph 9 above. And if perhaps as a technical matter, IRS publications are not substantial authority, does that mean taxpayers are unreasonable in relying on IRS publications? (I also believe that proposed regulations may be substantial authority.) There's a reason why our ancestors dumped that tea into Boston Harbor and our Founding Fathers adopted the Second Amendment!
14. In case you were unsure, your accounts at online poker companies, which the companies create outside of the United States, must be reported on an FBAR if the accounts exceed \$10,000 according to a district court in California in the *Hom* case. The poker accounts constitute "other financial accounts" and the assessment of the penalty for non-willful failure to file FBAR's was, accordingly, sustained.

15. IRS also explained its views on the tax treatment of Bitcoins and similar virtual currencies. Notice 2014-21 provides, generally, that Bitcoins are treated as property (rather than currency) for tax purposes. One consequence of such characterization is that a taxpayer who pays for property with Bitcoins will recognize gain if the fair market value of the property exceeds the taxpayer's basis in Bitcoins. If the Bitcoins are capital assets in the hands of the taxpayer, the gain will be a capital gain.
16. In a helpful development, a new Form 1023-EZ has been issued. The Form allows small charities (i.e., those with annual gross receipts of \$200,000 or less and total assets that do not exceed \$500,000) to make a simplified application for a determination letter as to the organization's exempt status.
17. How better to conclude this section of our materials than by quoting Senator Ron Wyden, current chairman of the Senate Finance Committee, who called the Internal Revenue Code "a rotting economic carcass that's infected with chronic diseases like loopholes and inefficiencies." Tell it like it is, Ron!

D. Other Noteworthy 2014 Developments.

1. In no particular order, we discuss below some other important and interesting developments in 2014.
2. A number of cases dealt with individual retirement accounts:
 - a. In *Dabney*, the taxpayer used funds from his self-directed IRA to purchase vacant land as an investment property. Schwab, the IRA trustee, did not permit such "alternative" investments, so Mr. Dabney withdrew the purchase price from his IRA. The court rejected his argument that the purchase was made on behalf of the IRA and agreed with the IRS that the payment was a taxable distribution. The 10 percent premature withdrawal penalty of § 72(t) also applied.
 - b. The Supreme Court held in *Clark v. Rameker* that inherited IRA's are not protected from creditors in bankruptcy.
 - c. Appeals Court decisions are awaited in *Ellis v. Commissioner* and *Peek v. Commissioner*, two cases that involve business acquisitions through an IRA. *Ellis* is appealing a Tax Court decision that the purchase by his IRA of an LLC that operated a used car business (and which then employed Mr. Ellis) was a prohibited transaction under § 4975. Mr. Peek and his partner, Darrell Fleck, caused their IRA's to buy the stock of a corporation, which then purchased the assets of a fire alarm business. The IRA owners guaranteed the repayment of purchase money notes given to the seller. The Tax Court held that the IRA's were disqualified because of the guarantees and taxed the gain on the later sale of the business to the IRA owners. Only the accuracy-related penalty is the subject to the appeal.
3. In *NPA Associates, LLC v. Estate of Dennis A. Cunning*, the court held that a tax lien on the taxpayer's interest in property owned jointly with right of survivorship was extinguished on the taxpayer's death where the joint tenant survived the decedent, and there was no lien against the joint tenant. Accordingly, on the taxpayer's death, there was no longer a property interest in the decedent to which the lien could continue to attach.

4. A New Hampshire district court ruled in *Baker* that a divorce court decree has priority over an IRS tax lien. The divorce court awarded an ex-wife her ex-husband's share of jointly owned real estate. That conveyance was not recorded. When the IRS filed a lien against the ex-husband and sued to force a sale of the real estate for the ex-husband's post-divorce tax liabilities, the court refused, because the divorce decree had vested ownership of the property in the ex-wife.
5. In *Fresenius Medical Care Holdings*, the tax consequences of the settlement by the taxpayer of False Claim Act investigations were considered where the parties specifically decided in the written settlement agreement not to agree on how payments were to be characterized. The taxpayer and IRS later agreed that the amount paid to settle criminal fines was non-deductible, and that an amount equal to single damages under the False Claim Act was deductible. A district court jury determined how much of the payment in excess of single damages was deductible as a compensatory amount. IRS argued on appeal that the absence of an agreement between the parties as to the characterization of the payment was fatal to the ability of the taxpayer to deduct the payment; this argument was rejected. Thus, said the First Circuit, courts are free to consider the economic substance concerning payments that are in dispute.
 - a. Recall, however, that the courts typically hold that the intent of the payor is generally the most persuasive evidence of the nature of the claims being settled, so a written settlement agreement that allocates payments to specific claims is still the best practice.
6. In PLR 201434022, IRS ruled that a virtual (i.e., online) sorority did not qualify as an exempt social club under § 501(c) (7). Operating a social network over the Internet, said IRS, is inconsistent with the definition of a "club," which requires an established membership, personal contacts and fellowship, and the comingling of members as a material element of the organization. The virtual sorority was for students of a for-profit online university.
 - a. Is IRS way behind the time here in a world of online education, online dating, online "personal contacts," and Facebook?
 - b. Mystery question of life – can one sneak one's girlfriend back into a virtual sorority after a virtual curfew?
7. IRS in 2014 made useful and important modifications to the Offshore Voluntary Disclosure Program. The "streamlined" voluntary disclosure program for "low risk" *nonresident* U.S. taxpayers, announced in 2012 was, in effect, extended to taxpayers living in the United States. Such taxpayers must pay a penalty of 5 percent on the value of their offshore accounts – the "regular" Offshore Voluntary Disclosure Program requires a 27.5 percent penalty.
 - a. Practitioners had complained for several years about the unfairness of the IRS' "one size fits all" approach to offshore voluntary disclosures, and some commentators noted that the harshness of the program would dissuade taxpayers who wished to make a clean breast of it from disclosing their offshore accounts. The streamlined filing program, as well as some modifications made in earlier years, has made the OVD program a more attractive option for eligible noncompliant taxpayers.

8. In an interesting decision, *ABC Beverage Corp. v. U.S.*, the 6th Circuit allowed a tenant that exercised an option to purchase the property it leased for “fair market value” to deduct a sizable portion of the amount it paid as a lease termination payment. The “value” of the property was disputed by the parties, and ABC based its deduction on the amount it paid in excess of the appraisals it obtained of the value of the property. The court rejected the IRS’s argument that § 167(c)(2) prohibited any allocation of the price to the leasehold interest, finding that the statutory language “acquired subject to a lease” applies only to acquisitions in which the lease continues after the purchase of the property. The Tax Court, in a 2000 case *Union Carbide Foreign Sales Corp.*, reached the opposite conclusion on this issue.
9. Losses that cannot be used because of the passive activity loss limitation rules become deductible under § 469(g) in the year in which the taxpayer disposes of his entire interest in the activity in a fully taxable transaction. In *Herwig v. Commissioner*, the Tax Court found that competing claims between the taxpayers and their lender prevented the 2008 foreclosure sale of the taxpayers’ rental properties from constituting a “fully taxable transaction.” In addition to suing to foreclose its mortgages on the properties Fifth Third Bank, the lender, sued for a deficiency judgment against the taxpayers. Taxpayers counterclaimed. The litigation was settled three years after the foreclosure sale with each party dismissing its claims against the other. The Tax Court held that given the uncertainties of the litigation, the ultimate accounting of the economic gain or loss from taxpayers’ investment could not be determined in 2008, the year of the foreclosure sale and, so, the taxpayers did not “fully dispose” of their activity in that year.
10. In another, important decision dealing with passive activity losses, the Tax Court, in *Frank Aragona Trust*, rejected the IRS’s position that trusts that manage rental real estate cannot qualify for active (i.e., nonpassive) business tax treatment. More specifically, the decision concludes that the activities of the *trustees*, including their activities as employees of the real estate entities owned by the trust, *should* be considered in determining if the trust “materially participated” in the real estate business. (There are no regulations dealing with material participation by trusts.)
 - a. Although not the issue in the case, the decision may permit trusts that own real estate interests to avoid the 3.8 percent Medicare Tax on net investment income under Section 1411.
 - b. Would there be any employment tax consequences to an active business trust or its trustees as a result of this case?
11. We noted earlier the increasing interests of a variety of businesses in exploring the creation of a REIT, to minimize the amount of income tax at the corporate level. Some of the activities of these REITs were “nontraditional” real estate activities, and the IRS has frequently been asked to rule on whether the assets of those activities constitute “real property.” To provide guidance on which all taxpayers can rely, and greater clarity to REITs and their advisors, the IRS this Spring issued proposed regulations that revisit the definition of “real property” for REIT purposes.
12. In an update to cases that we discussed last year, the 3rd Circuit joined four other Courts of Appeal in ruling that Fannie Mae and Freddie Mac are exempt from realty transfer taxes. The grant to them of general exemption from local taxes did not exceed Congress’s powers under the Commerce Clause.
13. In another update, the Tax Court, in *Craig Patrick*, again rejected an argument that a *qui tam* award paid to a whistle-blower under a False Claims Act case qualified for capital gains treatment, finding neither a sale or exchange nor a capital asset.

14. In *Cosentino*, the Tax Court determined that the portion of the proceeds from the settlement of an accountant's malpractice case, attributable to taxes, interest and penalties resulting from erroneous advice, were excludable from income. The accountants had recommended a like-kind exchange structure that the IRS determined was an abusive tax shelter.
15. A somewhat recent estate planning technique, involving fractional interests in artworks, was given a favorable nod by the 5th Circuit in the *Estate of Elkins* case. In *Elkins*, the decedent and his adult children owned interests in 64 works of art, with the decedent having a 50 percent or greater interest in each. The Tax Court rejected both the estate's claim for a greater than 50 percent discount for lack of control and marketability and the IRS's refusal to allow any discount, and permitted a 10 percent discount. In its reversal, the 5th Circuit upheld the valuation discounts offered by the taxpayer's experts.
16. Affirming the Tax Court, the 3rd Circuit held in the *R. Ball et al.* case that an S corporation's election to treat a subsidiary as a Qualified Subchapter S Subsidiary did *not* increase the basis of the S corp.'s shareholders in their stock. The deemed § 332 liquidation resulting from a QSub election, said the court, did not create an "item of income" for the parent for purpose of § 1366(a)(1)(A).
17. In *Netjets Large Aircraft, Inc. v. U.S.*, IRS is seeking \$643 million of transportation excise taxes, claiming that the fractional interest program involves commercial airlines to which the tax applies. In September, however, the taxpayer, moved for sanctions, asserting that the IRS "recklessly" destroyed key documents sought by the taxpayer and had done so after the lawsuit commenced. No reply yet from the court, but other spoliation of evidence issues confronting the IRS are noted immediately below.

E. Lost in the Funhouse.

1. Pity poor IRS Commissioner John Koskinen who had to endure a series of withering attacks at a June Congressional hearing relating to the political targeting scandal involving Ms. Lois Lerner and the Exempt Organizations Branch.
 - a. When Koskinen testified that he learned in February of this year that there was a "problem" in retrieving lost emails from Ms. Lerner's crashed hard drive but waited until June to inform Congressional investigators, saying he wanted to collect "all the facts," he unleashed the furor of the Republican members of the Ways and Means Committee.
 - b. Rep. Kevin Brady asked the commissioner, "At this point, why should anyone believe you? The IRS denied for two years targeting for political beliefs. That wasn't the truth. Then they said it was rogue agents. That wasn't the truth. You said you were also targeting liberal organizations. That wasn't the truth. ... This is the most corrupt and deceitful IRS in history."
 - c. Not to be outdone, Rep. Paul Ryan (the Republican vice-presidential candidate in 2012) weighed in: "I am sitting here listening to this testimony . . . I don't believe it. That's your problem. Nobody believes you. . . . You are the IRS You learned about this months ago, you just told us, and we had to ask you on Monday. . . . This is a pattern of abuse. . . ."

2. It could get worse. The IRS told Law360 in April that about half, or 59,000, of its computers still use the Windows XP operating system. Microsoft announced this April that it will no longer provide critical security updates for Windows XP. The IRS is in the process of upgrading its computer systems.
3. And at the risk of piling on, I note that in an analysis of IRS financial statements, the GAO concluded that the IRS is plagued by internal control deficiencies, particularly in the realm of its disposal of sensitive materials, increasing the risk that lost or stolen government property may go undetected.
 - a. So here's a thought to deal with this problem that I offer the service free of charge, being a public-spirited citizen. Why not simply crash the hard drives containing this sensitive material, as Ms. Lois Lerner apparently did with little or no difficulty. I think that would work!
4. In the competition for an advantage in global trade, "U.S. multinational firms have established themselves as world leader in global tax avoidance strategies," according to Edward Kleinbard, the former chief of staff of the Joint Committee on Taxation. With tongue firmly in cheek, Mr. Kleinbard added that our multinationals "are burdened by tax rates that are the envy of their international peers."
5. The Department of Health and Human Services announced in July that the famous website, healthcare.gov, had been breached by a hacker who uploaded denial of service malware. Denying service to that site is like taking water ice to Eskimos or coal to Newcastle!
 - a. The hacker immediately fled the site from fear of being trapped forever in the bewildering maze of tax provisions in the Affordable Care Act.
6. Kansas enhanced its tax revenues by seizing sex toys from a delinquent adult store chain, United Outlets, LLC d/b/a "Bang," and auctioning them off. The seized assets reportedly included lingerie, handcuffs, love swings for the porch, and assorted "whips, chips and dips." Democratic Kansas Senate Minority Leader Anthony Hensley criticized Republican Governor Sam Brownback over the auction, telling the AP that "Brownback is so desperate to fill the massive hole in the state budget caused by his reckless income tax cuts that the State of Kansas is now in the porn business."
 - a. Folks, you can't make this stuff up.
 - b. And, no, your author did not participate in the auction, despite working (you'll pardon the expression) very hard on these materials.
7. In the world of unintended consequences, consider the plight of Allgreens, LLC, a Colorado "marijuana dispensary," which is a Denver equivalent to Amsterdam's coffee houses, except that in Colorado, you can't (yet) buy "loosies." Federal banking regulations apparently forbid marijuana businesses (even legal ones such as Allgreens) from holding bank accounts, which prevented the taxpayer (or so it claimed) from paying taxes electronically through the Electronic Federal Tax Payment System, as required.
 - a. The IRS refused to abate the failure to deposit penalties after employment taxes were paid late, and the taxpayer has sought relief in the Tax Court.

- b. The IRS says Allgreens could have used a currency exchange or same-day loan establishment, but Allgreens responds that doing so would have violated anti-money-laundering laws.
 - c. Hopefully, justice will prevail and Allgreens can continue to carry out its critical business mission.
- 8. Having heretofore considered dope, porn, hacking and Obamacare, we turn next to gambling, or “gaming” as its supporters euphemistically refer to it. In *Greenwood Gaming and Entertainment, Inc. v. Commonwealth*, the Pennsylvania Supreme Court reversed a lower court ruling that held casinos could not deduct the cost of player rewards before calculating their slot machine tax liability. The decision allows the appellant, Parx Casino, and other Pennsylvania casinos to deduct certain player rewards promotions, as well as payouts from the slot machines, in computing the “gross terminal revenue” tax base. So keep those “RFB comps” coming.
- 9. Bloomberg reports that in 2012, a Japanese company - Yamazaki – shockingly beat out 300 of the world’s single malt scotches (including Scotland’s finest) in a blind tasting test. Yamazaki’s 25-year old scotch was the winner. Your author would be most pleased to be invited to judge next year’s competition.
- 10. The New Jersey Department of Revenue, in a March announcement, felt compelled to remind taxpayers and pharmacies that the sales tax exemption for prescription drugs applies only to medicines prescribed for humans, not animals, even when the same medicine is prescribed for pets and their masters. Word up – if Fido needs Valium, get a prescription from your shrink, not the vet.
- 11. European Union tax authorities are attempting to crack down on a number of special tax deals offered to U.S. multinationals by countries such as Ireland, the Netherlands and Luxembourg, claiming these deals constitute illegal state aid. Tax deals in the Netherlands, for instance, have made it a more attractive destination than pot ever did.
 - a. Ireland announced that it was phasing out a “technique” apparently pioneered by Apple sometimes known as the “Double Irish,” or the “Double Irish with a Dutch sandwich,” which involves the use of both a Dutch and an Irish subsidiary. A U.S. Senate Report said Apple had negotiated a tax rate in Ireland of less than 2 percent while managing to transfer to Ireland \$74 billion in worldwide sales. Apple said its success in Europe “is the result of hard work and innovation by our employees, not any special arrangements with the government.” Apple’s tax department deserves much credit for its innovation skills.

F. A Confederacy of Dunces.

- 1. Two of the stars of the Bravo reality show “Real Housewives of New Jersey,” Teresa and Giuseppe Giudice, were sentenced to 15 months and 41 months in prison (respectively) for fraud, bankruptcy fraud and tax evasion. Among other things, they obtained \$4.5 million in a series of bank loans with patently fraudulent loan applications. They’ll next star in the Real Hoodlums of Rahway.

2. Attorney Steven Siff, a partner in the Miami office of mega-firm McDermott, Will & Emery, was sentenced to 13 months in prison after pleading guilty to failing to file returns for 2009-2011. Siff earned about \$2.1 million from his firm in those three years.
 - a. It could have been much worse. According to the information filed by the government, Siff had failed to file returns since 1997 and earned in excess of \$8 million during that period. A McDermott spokesman said that Siff's "personal tax problems did not affect his professional performance. ..." The firm apparently had no idea that its partner was a non-filer.
3. Meanwhile, the former head of Jenkins & Gilchrist's Chicago office, Paul Daugerdas, was sentenced to 15 years in prison for orchestrating a \$7 billion tax fraud scheme. Judge William Pauley said Mr. Daugerdas would go down as "the architect of the greatest tax fraud in U.S. history," and also ordered Mr. Daugerdas to pay \$371 million in restitution and forfeit \$167.7 million.
 - a. Three partners at accounting giant BDO Seidman were also sentenced to prison time in connection with the same tax-shelter scheme.
 - b. Jenkins & Gilchrist itself shut down in 2007 after a \$76 million settlement with the IRS.
4. The desire to evade taxes runs deep in the human breast and is not confined to practitioners. Consider, for example, soccer stars such as now retired Uli Hoeners of FC Bayern Munich who received a three-year sentence in Germany for evading 3.5 million Euros of tax and squirreling the funds away in a Swiss bank account, or Argentina-born Lionel Messi of FC Barcelona, perhaps the best player in the world, who is the subject of tax fraud charges in Spain. Messi's father, Jorge, is also under investigation for allegedly evading 4 million Euros in tax, proving once again that the apple never falls far from the tree. Lionel reportedly earns more than 20 million Euros a year, so don't cry for him, Argentina.
5. Who's the largest alleged delinquent taxpayer in Philadelphia?⁵ Why, according to the city, its SEPTA. The issue is a curious one, because SEPTA is tax-exempt, but a 2003 State Supreme Court decision held that SEPTA had to pay real estate taxes on property it leased to for-profit businesses. The city had for many years sought to tax SEPTA on all of its property, giving rise (with interest and penalties going back many years) to an asserted debt of \$22 million. In any event, as part of a new 30-year contract with the transit agency, the city agreed to forgive the \$22 million which SEPTA denied owing anyway. Terri Williams, a SEPTA spokesman, told Law360 that "we are not deadbeats..."
6. Former PA Senator Vince Fumo, who was convicted on a variety of corruption charges in 2009, recently won a District Court case that prevented the IRS from enforcing a \$3.6 million jeopardy assessment against him. While not ruling on the merits of the IRS assertions as to Fumo's outstanding tax liability, Judge Buckwalter concluded that the rarely used jeopardy assessment procedure was unreasonable in this case.

⁵ The list is a long one; except for Detroit, Philadelphia reportedly leads the nation in property tax delinquencies.

7. In May, Credit Suisse pled guilty to helping more than 22,000 Americans evade taxes and agreed to pay a whopping \$2.6 billion fine. The guilty plea was a departure from what had been the normal practice of the Justice Department to allow financial institutions to enter into deferred non-prosecution agreements. Senators Carl Levin and John McCain blasted the deal as too lenient, but prosecutors feared that not accepting the plea agreement might cause the failure of Credit Suisse's U.S. operations, with a resulting loss of thousands of U.S. jobs and disruption to the industry. As the comic said, "too big to jail."
8. Republican Congressman⁶ Michael Grimm of New York was indicted for failing to report more than \$1 million of receipts from and employing undocumented workers in his restaurant, "Healthalicious." Evading taxes can be dangerous to your healthalicious, Mike.
9. Closer to home, Chuck and Mary Bangle, owners of the famous Manco & Manco pizza shops at the Jersey Shore, were charged with several counts of tax evasion for failing to report more than \$980,000 in income. Rather than try to "Walk Like an Egyptian," these Bangles will likely learn the "perp walk" as they develop their new product, jailhouse pizza. Oh those Allenwood nights!
10. Phillip Monroe Ballard, age 72, was sentenced to 20 years in jail for attempting to hire a hit man to murder the federal district court judge presiding over his tax fraud trial. Mr. Ballard argued that he wasn't "really" trying to murder the judge. In the immortal words of Dr. Phil, Mr. Ballard, "What the hell were you thinking?"
11. But the "worst taxpayer of the year award" goes to technology entrepreneur, Robert T. Alpert, who was denied a \$4 million loss deduction after he stole money from his mother to prop up his failing business. Alpert used the money to buy stock in his company for Mom. Mom threatened to sue him when she learned of this theft, so Alpert promised to indemnify her if the shares had to be sold at a loss (which indeed turned out to be the case). If that weren't bad enough, the taxpayer then wrote a letter to his mother stating that the payments he had made to support her lifestyle over the prior six years exceeded the \$4 million she lost.
 - a. My former ROTC battalion commander, Judge Halpern of the Tax Court, had no difficulty in disallowing any expenses which Alpert paid on his mother's behalf, concluding that the origin of loss was Alpert's efforts to repair a personal relationship with his mother, and not the result of a business activity.
 - b. So because retroactive abortion is not yet an option, Robert T. Alpert wins our coveted 2014 award as worst taxpayer of the year.

And so, my friends, as we look forward to celebrating with our loved ones during this season of miracles (and, likely, to copious amounts of snow), I leave you again with my favorite belief, namely that "the best things in life aren't things."⁷

And from our house to yours, we wish each of you season's greetings and a healthy and prosperous new year.

Dennis Cohen

⁶ Because both Republican and Democrat civil servants seem equally willing to ignore the laws they pass, your author continues to be a registered "None of the Above Party" voter.

⁷ In a somewhat similar vein, my wife reminds me of Coco Chanel's famous dictum that "The best things in life are free. The second best things are very expensive."