BRINDISI TAX ACADEMY

2013 YEAR-END TAX UPDATE

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Dennis L. Cohen
Cozen O'Connor
1900 Market Street, 3rd Fl.
Philadelphia, PA 19103
dcohen@cozen.com | 215.665.4154

SOME THOUGHTS FOR 2014 AND BEYOND ON TAXES, TAX REFORM, MID-TERM ELECTIONS AND OUR FUTURE

> ***"Tax reform is taking the taxes off things that have been taxed in the past and putting taxes on things that haven't been taxed."***

- Art Buchwald

> ***"The present tax code is about 10 times longer than the Bible, a lot more complicated, and, unlike the Bible, contains no good news."***

- Former U. S. Senator Don Nickles

> ***"Next to being shot at and missed, nothing is quite as satisfying as an income tax refund."1***

- F. J. Raymond

Although not directed to the political impasse which led to this year's shutdown of the government, the following observation of H. L. Mencken rings as true today as it did some 90 years ago:

> ***"Under democracy, one party always devotes its chief energies to trying to prove that the other party is unfit to rule - and both commonly succeed, and are right."***

1 Long-time readers will recall that tax refunds, like Santa Clause and the Publishers' Clearinghouse, are three things that never come to your author's door.

I. A LOOK BACK AT 2013 TAX MATTERS, "GANGNAM STYLE"

A. Some Random Observations.

1. When we penned last year's *Update* for you, dear reader, this fair country of ours stood six feet from the edge of the "fiscal cliff" (i.e., the sun setting of the Bush-era tax cuts). Fortunately, thanks to the wise and generous-of-spirit ladies and gentlemen whom you and your fellow citizens sent to Washington to represent you, a fall off the fiscal cliff was averted.

2. There was, however, a "small price" to pay for stepping back from the edge, in that virtually all taxpaying Americans (a minority, that) have seen (and, if practitioners will ever be able to prepare and file their returns for them, will *really* see) that their federal income taxes went up in 2013.

    a. These tax increases were principally accomplished by raising tax rates on those favored few whose income exceeds $400,000, but the phase-out of the ability to benefit from the deduction for personal exemptions and limitations on the use of itemized deductions, will affect numerous others.

    b. All employees were impacted by the return of the OASDI portion of the FICA tax rate to 6.2 percent from 4.2 percent where it had gently resided for the prior two years and, to add injury to insult, the Medicare tax rate was increased by 0.9 percent on certain high earners.

    c. The new 3.8 percent tax on net investment income (§ 1411) went into effect this year. This was enacted so that the investor class would feel that they, too, like the working class, were helping Uncle Sam. (Of course, on that theory, well paid workers with investment income are encouraged to feel doubly blessed.)

3. Not all the tax news is bad, however. Because of some of the tax increases mentioned above, fewer Americans will have to pay the dreaded AMT, because their regular income tax will be so much higher! (That's known as "tax humor," folks.)

4. Fears of toppling over the fiscal cliff brought a flurry of deals at the end of 2012, as well as accelerated bonuses and dividends, so practitioners were able to rejoice at year-end 2012 despite the added work. The inevitable give-back took place early in 2013.

5. 2013 is not an important election year, so we were spared the tedium of watching Republican Party candidates vie with one another to see who could come up with the most creative new tax reform ideas. With mid-term elections scheduled in 2014, expect that reprieve to end, although I suspect Herman Cain's "nine, nine, nine" proposal will not resurface.

6. As noted above, political distemper shut down the government for some 16 days this Autumn. While some may find it incongruous that in 2013, more money was raised from higher taxes to pay for less government, a number of neighbors and friends of mine at Classic Pistol the other night were allowing as how they would volunteer to pay *even more* taxes in exchange for even less government. Seems like a lot of folks in Bucks County hold with Emerson that "that Government is best which governs least."

7. Sources report that the Senate Finance and House Ways and Means Committee Chairmen have been working feverishly (and quietly) to draw up major tax reform legislation that would be agreeable to both parties. Even assuming the framework of such legislation can be arrived at, this is more likely to be a 2014 or 2015 than a 2013 phenomenon.

    a. For those who scoff at the notion that the parties might ever agree on major tax reform, I remind them that there were plenty of skeptics who in 1986 bravely assured their listeners that no such reform was possible; the result, of course, was the Internal Revenue Code of 1986 which, *at the time*, took huge strides toward tax simplification. That subsequent administrations and Congresses encrusted the law with a bewildering number of new tax expenditures does not prove that major tax reform cannot get done; whether if done it can stay done is another story.

8. I had hoped to report to you on the tax aspects of the Affordable Care Act, but despite repeated attempts, I was unable to get on the website. Mr. President, "you did not build that." The Affordable Care Act is a most important and curious law, not the least because the administration seems free to postpone certain of its provisions by fiat or, perhaps more technically, by executive order, despite what you learned in civics classes all those years ago.

    a. As things stand, at the time of these scribblings, the individual mandate provisions of the Act are scheduled to take effect next year. We'll see. Recall that last year, in *National Federation of Independent Businesses et al. v. Sibelius*, the Supreme Court concluded that the individual mandate provisions were a tax, not a penalty and, as such, the Act passed Constitutional muster.

    b. There is no truth to the rumor that the geniuses who designed the government's health care website have now turned their attention to the drafting of 2013 tax return forms, but the start of tax season now seems certain to be delayed longer than usual. More on that below.

9. Except for the legislation that avoided a fiscal cliff calamity, touched on briefly above, there was little important new tax legislation in 2013. Nevertheless, there were, as usual, numerous tax-related court decisions, rulings and other developments throughout the year and, as is our charge, I have summarized in these materials some of those items that I found to be most important, surprising, or just plain stupid (but amusing). As always, I alone (and neither my law firm nor my colleagues in my Tax Department) am responsible or to blame for the content of these materials, which I hope you find useful and entertaining.

    a. As I always tell my readers, if you detect any errors, I ask only that you not tell my grandchildren who still believe I am all-knowing and infallible (except, perhaps, for my resolute belief in and unrequited love for the Philadelphia Eagles). My daughters, of course, know better, and my wife concluded from "I do" that she was by far the smarter of the two of us, an observation that she has not infrequently reminded me of these last 43 years.

10. And we will, as usual, announce the winner of the annual "worst taxpayer of the year" award. Lord knows, there were plenty of worthy candidates.

II. SELECTED TAX DEVELOPMENTS.

A. By the Numbers.

1. The marginal income tax rate for 2014 (39.6 percent) will apply to the taxable income of individuals and married couples filing jointly exceeding $406,750 and $457,600, respectively, up from $400,000 and $450,000.

2. The standard deduction in 2014 rises to $6,200 from $6,100, and the personal exemption increases by $50 to $3,950. For married couples, the phase-out of the deduction for the personal exemption starts with AGI of $305,050, and the deduction is completely eliminated once AGI reaches $427,550.

3. The FICA wage base increases to $117,000, a $3,300 jump.

4. The annual dollar limit on contributions to health care flexible spending accounts is unchanged at $2,500.

5. Although certain retirement plan limits were increased (e.g., the limit on the maximum annual pension under a defined benefit plan rose from $205,000 to $210,000), the § 401(k) contribution limit of $17,500 remains in effect for 2014. Similarly, the $5,500 per year limit on catch-up contributions for participants age 50 or above was not increased.

6. The estate tax exclusion rises from $5.25 million to $5.34 million.

7. The excise tax on arrow shafts (§ 4161(b)(2)(A)) for 2014 is $0.48 per shaft, and isn't it time someone told Congress that "shaft" is an unfortunate term to use in the context of taxation.

8. The Office of Management and Budget reported that the government shutdown prevented IRS from collecting approximately $1 billion per week. Worse, said OMB, the cost to the government of interest on delayed refunds and late payments under federal contracts will be in the billions of dollars.

9. During last year's presidential election campaign, Governor Romney stated that in 2010, 47 percent of Americans didn't pay federal income tax. (His exact language was somewhat more colorful.) Now, the nonpartisan Tax Policy Center has reported that for 2013, the percentage of Americans who are not expected to have to pay federal income tax has declined to 43 percent, principally, the Center said, because more Americans are working and/or earning more money. (Gee, those economists are really astute.) The report further estimated that some two-thirds of the 43 percent pay payroll taxes.

B. Practitioners and the Profession.

1. Because the scheduled testing process for the IRS's tax return acceptance systems fell during the government shutdown, the IRS has announced that it now expects to push back the start of the filing season from January 21 to February 4, although Service representatives said they were hopeful that they could shorten the delay by "speeding up testing procedures." We all saw how well that worked for healthcare.gov. In no event is the start of the filing season expected to begin before January 28.

a. New initiatives to detect and prevent identity theft and refund fraud – which we discussed in a prior Seminar – are also slowing the process.

b. For those clients of yours hoping for early refunds, too damned bad. I'm sorry to note that once again my political party, the "None of the Above" Party," failed to elect a single candidate in 2013, despite fielding by far the best slate of candidates, so don't blame me.

c. As of the moment, neither the April 15 due date nor the October 15 extended due date will be pushed back, says the IRS, because those dates are set by law. (As noted, that didn't seem to be an impediment with the Affordable Care Act.) This year's October 15 deadline for 2012 returns was not extended for this reason, even though the government was shut down on that date.

d. Similarly, PTIN renewals for 2014 (which are now said to be open) are not extended. Remember to pay your $63 and renew before year's end.

2. IRS has begun sending warning letters to practitioners believed to be filing inaccurate earned income tax credit claims. Preparers are warned of penalties and the possible revocation of e-filing privileges and may even be barred from preparing returns.

3. In perhaps the most important tax case of the year, *U. S. v. Windsor*, the Supreme Court struck down as unconstitutional Section 3 of the Defense of Marriage Act, which generally defined marriage as the union of one man and one woman. In the wake of the *Windsor* decision, the IRS allowed employers to make payroll adjustments for same-sex couples without having to file Forms 941-X by adopting one of two alternative special administrative procedures, including correcting employment tax overpayments on the 2013 fourth quarter Form 941.

a. In addition, in Rev. Rul. 2013-17, IRS stated that legally married same-sex couples would be treated as married for all federal tax purposes, including gift and estate taxes. Rev. Rul. 2013-17 sensibly adopted a "place of celebration" approach to same-sex marriage, ruling that couples legally married in one domicile were permitted to file joint returns even if now living in a state that did not recognize same-sex marriages.

b. Registered domestic partners or individuals in a civil union will still **not** be regarded as married – an actual marriage is required. (See the IRS FAQ's on registered domestic partnerships.)

c. We have been advising practitioners for a number of years to consider filing protective refund claims for same-sex couples by preparing joint returns, in order to prevent the statute of limitations from running. That option is now clearly available for open years.

d. But, as is always the case in the wonderful world of tax law, some things always remain unclear. Thus, in late October, Rep. Allyson Schwartz (D-Pa.), a member of the House Ways and Means Committee, wrote to Treasury Secretary Lew and Acting Commissioner Werfel for guidance as to the status of the approximately 200 same-sex couples who were "married" (we think) in Montgomery County, Pa., even though the Commonwealth of Pennsylvania does not recognize these marriages. We can't wait for that guidance, although one certainly hopes it will be forthcoming before April 15.

e. Shakespeare said "let me not to the marriage of true minds admit impediments," but it's not a one-way street for all same-sex couples in tax-land. Happily married, high earning gay and lesbian couples may now find themselves subjected to the same "marriage penalty" as affects heterosexual couples!

4. Numerous advancements in modern life (e.g., surfing, Daisy Dukes, Proposition 13, and Knott's Berry Farm, just to name a few) have their origins in California. And so, unsurprisingly, and not to be outdone, Governor Jerry Brown signed legislation this fall that allows children in California to have more than two legal parents. The law is said to be a reaction in part to a 2011 court decision in which parental rights were denied to the biological father of the child of a lesbian couple. Seems that after the couple split up, one of the partners was impregnated by the biological father before the two women subsequently reconciled. When their relationship again soured in a fight that left one woman in jail and the other hospitalized, their daughter was sent to foster care when the court ruled the biological father did not have parental rights.

    a. Separated or divorced spouses each claiming dependency exemptions for the same child is the most common tax return problem encountered by the IRS. In California, this problem just got worse.

5. In March, the IRS reported that H&R Block – for want of a better term – screwed up more than 600,000 returns it prepared by improperly filing Form 8863, the form used to claim educational credits. The problem, it seems, was in leaving certain mandatory fields on the form blank. In the past, leaving these fields blank to signify "no" was acceptable, but the IRS now requires preparers to enter "N" for "no" on the form.

    a. Practice tip – in "getting to no," H & R Block, it pays to read the instructions to the forms you're completing.

    b. This mistake delayed the payment of thousands of refunds by up to six weeks.

6. When practitioner errors are more than just accidental, the consequences can be severe. Thus, for example, in the *Erwin* case, a district court in North Carolina held two brothers in an accounting firm liable for a $325,000 trust fund recovery (or 100 percent) penalty under § 6672, even though they were not owners, officers or directors of their financially distressed client. The brothers, who owned the Buddy Light Accounting & Tax Services firm, managed payroll, accounting, withholding tax depositing and accounts payable for their client, GC Affordable Dining, Inc. On several occasions, the accounting firm advised GC's management that it lacked sufficient funds to meet payroll and all of its other obligations to creditors, tried to help GC devise a payment plan with IRS, communicated the proposed plans to the IRS, but nevertheless continued at the client's direction to issue payroll checks limiting withholding taxes and paying other creditors, rather than depositing withheld employment taxes with the IRS.

7. The IRS and the Justice Department continue their efforts to combat refund fraud and identity theft and have announced additional initiatives for the 2014 filing season. In February, IRS reported that the joint initiative with the Department of Justice led to 734 enforcement actions, principally in the criminal arena. In addition, a special compliance initiative dealing with money service businesses was undertaken in 17 "high-risk" areas, to try to ensure these businesses were not assisting refund fraud or identity theft. Five of the 17 high-risk areas were in California, but Philadelphia and New York made the list as well.

8. In fiscal year 2012, the IRS received 332 tax-related whistleblower claims. The number of alleged tax cheats who apparently met the required $2 million in tax threshold exceeded 650 taxpayers. (More on whistleblowers later in these materials.) For 2012, the IRS collected $593 million from taxpayers identified through whistleblower leads and paid $125 million to whistleblowers. Despite these results, the IRS has been criticized by certain members of Congress for being slow in investigating such tips and in paying rewards to informants.

C. Some Other Noteworthy 2013 Developments.

In no particular order, we discuss below, as always, a number of interesting or important tax developments this year.

1. S Corporation matters:

    a. The attentive reader (some of you must have made it this far) will recall that for several years now, we have discussed the efforts of owners of S corporation service businesses to minimize the amount of distributions that they receive by way of compensation. Last year, for example, we cited the extraordinary results of two great Americans, Newt Gingrich and John Edwards, who received boatloads of money but little salary from their S corps. The principal motivation for this phenomenon, of course, is the avoidance of employment taxes, and the stakes will be even higher going forward as more taxpayers select the S corp., rather than the LLC, as the preferred choice of entity in hopes of both limiting employment taxes, and avoiding the 3.8 percent tax of § 1411 on net investment income.

    b. By way of illustration, in *Sean McAlary*, the Tax Court had occasion to analyze this issue in a case involving the reasonable compensation earned by Mr. McAlary, the sole owner, director and officer of a real estate business bearing his name. For 2006, the year in issue, he was also apparently the only employee to hold a real estate broker's license. McAlary had an agreement with his company pursuant to which his base pay was set at $24,000/year. In 2006, the company had $518,000 of gross receipts and $232,000 of net income, and distributed $240,000 to McAlary. Presumably because his salary was so meager, or because his company neglected to issue a form W-2, McAlary forgot to report his $24,000 in wages, although he did list the company's profits on his Schedule E. At trial, the IRS argued that the taxpayer's reasonable compensation should be based on an hourly rate of $48.44, or $100,755 for the year. The taxpayer said it was the now remembered $24,000. The court rejected both the taxpayer's reliance on his agreement with the company and the findings of the IRS' expert and, instead, determined that an hourly rate of $40 was reasonable, thereby arriving at the compensation figure for the year of $83,200. The court relied on the factors for determining reasonableness set out in such cases as *Charles Schneider & Co. v. Commissioner* and *K&K Veterinary Supply*.

    c. Section 6501(e) of the Code extends the normal three-year statute of limitations on the determination of a deficiency to six-years where there is a 25 percent omission from gross income. Items that are "adequately disclosed" in the return, however, are not considered omitted. In CCA 201333008, the IRS concluded that where more than three years after an individual filed Form 1040 for a year, reporting income from an S corp., the S corp. filed its Form 1120-S for such year reporting that the taxpayer's share of S corp. income was more than 125 percent of what the taxpayer reported, the six-year statute did apply. In other words, information shown on an S corp. return filed after its shareholder filed his own return cannot be considered "adequately disclosed."

d. I suspect it will not shock you, dear Reader, to learn that business partners sometimes just don't get along. Thus, in *Kumar*, the taxpayer, a 40 percent minority partner in a medical practice, was shut out of the operation and management of the business by his 60 percent partner, Dr. Woody. (Lord help the patients of that radiation oncology practice!) In 2005, the year in issue, the business made no distributions to its shareholders, although it did pay a handsome salary to Dr. Woody. Dr. Kumar got nothing – except for a Schedule K-1 reporting his $216,000 share of business income and $2,300 of interest income. Kumar listed the stock in the business on his Schedule E but reported none of the income, on the theory that he was no longer a beneficial owner of the shares in 2005. The Tax Court could find no authority permitting one shareholder to take beneficial ownership away from another shareholder, absent an agreement between them or a provision in the articles of incorporation or by-laws to that effect. Accordingly, the court held that Kumar remained the beneficial owner of the shares and had to include his 40 percent share of the profits in income.

(My take away? Doctors can sometimes be – how can I put this nicely – cheap. Woody was too cheap to buy out Kumar, and Kumar was too cheap to hire counsel to get after Woody. I freely acknowledge that most folks don't like lawyers but sometimes, we're a necessary evil, with necessary being the operative word.)

2. Under the *qui tam* provisions of the False Claims Act (FCA), private individuals (referred to as relators) can, in the name of the government, sue persons who present false or fraudulent claims for payment to the United States. Such whistleblowers often receive 15 percent to 25 percent of the net amount received by the government in prosecuting the claim. Although legal fees paid by relators in pursuing claims under the FCA and numerous – but not all – other laws – See § 62(a)(20)-(21) are now deductible above-the-line, such was not always the case, with the result that various limitations on the deductibility of itemized deductions could greatly reduce the net after-tax result to the relator. In *Bagley v. U.S.*, in an effort to overcome the treatment of counsel fees as itemized deductions, our hero, Mr. Richard Bagley, persuaded a District Court Judge that he, Bagley, was actively engaged in the trade or business of being a private attorney general and, as such, that his legal fees were ordinary and necessary business expenses, not itemized deductions. For the years 1994 through 2003, Bagley earned $36 million in fees for prosecuting his former employer, TRW, Inc. for false claims, and paid more than $18 million in counsel fees.

a. Because § 162 does not define the term "trade or business," the court applied the nine factors in the regulations to the hobby loss rules of § 183 in determining that Bagley was actively engaged in a trade or business.

b. Although Bagley is undoubtedly a hero to his wife and children, and his service to his country should certainly be acknowledged, numerous other whistleblowers may now consider Bagley a selfish villain. For if whistleblowing (or more properly, I suppose, service as a private attorney general) is now a trade or business, wouldn't fees paid to relators be net earnings from self-employment? And, if net earnings from self-employment, wouldn't the net recovery be subject to self-employment income tax? And, if the Code now specifically permits an above-the-line deduction for counsel fees anyway, will IRS now change its litigating position on this issue and agree with Bagley that fees paid to a relator arise in a trade or business?

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3. I would be remiss if I failed to make several observations on 2013 developments relating to exempt organizations.

    a. The scandal involving the Exempt Organizations Branch's treatment of conservative and/or Tea Party-related organizations' applications for recognition of exemption under § 501(c)(4) claimed a major victim when, after reviewing the TIGTA Report on the scandal, the IRS commissioner Steven Miller resigned.

    b. The turmoil in the EO Branch following the scandal, and the numerous re-applications filed by nonprofits whose exempt status had been revoked for failure to file returns for three consecutive years, has resulted in a massive logjam in trying to get applications approved. At the time these materials were penned, the IRS website suggested that applications from May, 2012 (that is not a typo, friends) were now being processed, although your author's recent personal experience has been modestly better in the case of applications not likely to raise any questions or require supplemental information.

    c. To further deal with the blowback from the scandal, the IRS this summer announced an expedited approval process which certain § 501(c)(4) applicants of a "political" bent may elect, provided the review of their applications had been pending for more than 120 days.

    d. The IRS reminds social welfare organization applicants of the kind described in the immediately preceding subparagraph that political intervention activities cannot be the organization's primary activity. In a helpful statement, the IRS sought to clarify what's meant by "political campaign intervention" by specifying several examples of items that will be considered direct or indirect participation or intervention in a campaign. The information appears principally in a June 24 Report titled "Charting a Path Forward at the IRS: Initial Assessment and Plan of Action."

    e. Proposed regulations providing guidance on qualification issues for § 501(c)(4) organizations were issued on November 26, too late for inclusion with these materials. The proposed regulations create a new term, "candidate-related political activity," which is not within the permitted purview of qualifying (c)(4) organizations.

    f. In TAM 201318034, the IRS refused to grant § 7805(b) relief to limit the impact of the retroactive revocation of the exempt status of a credit counseling organization. As a reason for this denial, the IRS noted that the organization's operations were in fact different from those outlined in the exemption application. Credit counseling organizations have had a checkered history with the IRS.

4. The *Peek and Fleck* case is an important reminder of the need to exercise extreme care in and to consult with an employee benefits expert before "co-investing" with your IRA. In *Peek and Fleck*, the Tax Court held that the individual taxpayers' guarantee of a purchase money note given by a company that was owned by their IRA's, to enable the company to buy the assets of an alarm and fire protection system business, was an indirect extension of credit to their IRA's, a prohibited transaction under § 4975(c)(1)(B). As a result, the IRA's ceased to be IRA's under § 408(e)(2), and the individuals had to recognize gain on the subsequent sale of the alarm company stock by the former IRA's.

5. In *Vancouver Clinic Inc. v. U.S.*, a District Court in Washington found that "loans" made to doctors under physician recruitment agreements were, in essence, advances of compensation, and that the clinic was liable for some $600,000 in FICA taxes and interest. The court, in analyzing the facts, concluded that in this case, the parties did not intend any repayment of the loans. Physician recruitment agreements are common in the industry as inducements to physicians to locate or relocate their practices. Practitioners must be careful to make sure that advances intended as loans have the characteristics of such.

    a. But in *John E. McAllister, Jr.*, a case worth re-reading at Christmas, the Tax Court held that an employee who received loans from his former employer that he didn't and couldn't repay had cancellation of indebtedness income and not compensation. Because of the insolvency exception, a portion of the loan balance was excluded from the taxpayer's income when the successor to his former employer cancelled the loan. The taxpayer was supposed to repay the loan from bonuses under company incentive plans; the loans had no repayment date and did not require interest. In 2007, when McAllister no longer worked there, the company was sold to a successor that issued the taxpayer a Form 1099-MISC in the amount of the loan, classifying it as nonemployee compensation. The Tax Court happily found that the classification of the forgiven debt as nonemployee compensation was "a bookkeeping error," since McAllister was never going to get a bonus from the company.

Merry Christmas, Mr. McAllister, and God Bless.

6. Readers are directed to FAA20133501F in which the IRS provides advice as to the treatment of the payment of plaintiff's attorney's fees by an employer or former employer settling claims for violation of various federal employment and civil rights related laws. Although this Field Advice breaks no new ground, it is a useful refresher of the income and employment tax, and information reporting, rules that apply to such payments.

7. In the international tax noncompliance arena, a judge in the Northern District of California authorized IRS to serve a John Doe summons on Wells Fargo Bank, seeking information about U. S. taxpayers who maintain offshore accounts at First Caribbean International Bank. First Caribbean has no branches in the United States but is allowed to access the U.S. banking system through a correspondent account at Wells Fargo. Reportedly, information about First Caribbean depositors was developed from leads obtained in the Offshore Voluntary Disclosure Initiative.

    a. In a rather harsh development, attorneys report that "dozens" of U.S. taxpayers who were previously accepted into the OVDI program have now been disqualified from participation. All or nearly all of these taxpayers are believed to have maintained accounts at Bank Leumi, an Israeli Bank. Sort of gives a whole new meaning to the term, the "Chosen People." Practitioners believe the disqualification notices mean that the bank has been cooperating with an ongoing IRS investigation. Banks in Israel, Central America and India (as well as Switzerland) are rumored to be subjects of interest to the IRS.

    b. Some noncompliant taxpayers have no shame. So, in *Thomas v. UBS*, the dismissal of a lawsuit against the Swiss bank brought by U.S. account holders, who participated in the OVDI, seeking reimbursement for their fines and penalties, was affirmed by the 7th Circuit. The plaintiffs alleged that UBS had given them faulty tax advice and should have kept them from violating the tax law, but were chastised by the court as tax cheats whose lame claim wouldn't be heard. Reminds me of that old country song where the man says "The devil made me do it the first time, but the second time I did it by myself."

8. Over the last 15 or so years, many mutual life insurance companies converted to stock companies in order better to access the capital markets to raise funds and/or to diversify into other businesses. Commonly in such "demutualizations," policyholders received stock (or stock and cash) in exchange for the mutual rights they had under their "membership interests" as policyholders. The question of whether the policyholders have basis in those shares, for some or all of the policy premiums they paid, has been the source of some controversy.

    a. IRS has taken the position that all of the premiums paid by a policyholder were used to purchase and carry the policies, and that none of the premiums are allocable to the mutual rights given up in exchange for the stock. Accordingly, the policyholder would have a zero basis in the stock; unsurprisingly, many taxpayers disagree with this analysis.

    b. In *Bennett and Jacquelyn Dorrance v. U. S.*, the District Court in Arizona addressed this issue. There, the taxpayers had formed a grantor trust that purchased approximately $88 million in life insurance coverage from five mutual insurance companies. Over a four-year period, all five companies demutualized. The taxpayers received stock in these companies worth $1,794,771; the stock was sold in 2003 for $2,248,806. The taxpayers reported gain based on a zero basis in the stock, then filed a refund claim arguing that the "open transaction" doctrine governed the demutualizations. On this theory, the proceeds from the sale of stock would first be a return of capital (i.e., the policy premiums), so there would be no gain from the sale until the basis in the shares was fully recovered.

    c. The court rejected the views of both parties and undertook its own analysis. Reg. § 1.61-6(a) provides that where a taxpayer sells one part of a piece of property, the cost of the property must be equitably apportioned among its parts, and this the court set out to do. The court looked to how the insurance companies in their IPO's determined how many shares each policyholder received. It determined that the sum of the IPO value of shares allocated (i) to the value of the policyholder's lost voting rights (a fixed component), and (ii) 60 percent of the IPO value of shares allocable to the loss of other rights in the demutualization, a variable component intended to approximate the policyholder's past contributions to the companies' surplus, was the measure of the basis in the shares. (The remaining 40 percent was an estimate of projected future contributions to surplus and so could not be included currently in basis.) In essence, the taxpayers paid for the stock by relinquishing voting rights and contributions to surplus, the court's measurement for basis.

9. In PLR 201317010, the IRS concluded in technical advice that only the activities of a trustee that were performed in a fiduciary capacity count for purposes of determining whether two trusts materially participated in an activity carried on by an S corp. of which the trusts were shareholders. The fact that "A" (a "special trustee" of the trusts in question who had control over decisions affecting the disposition and voting of their S corp. stock) was president of the S corp. and, in that role, was actively involved in the business was deemed irrelevant by the IRS. Citing the legislative history to § 469 (because no regulations dealing with material participation by trusts or estates have ever been promulgated), the IRS determined that only the activities of a fiduciary "in his capacity as such" are relevant for material participation purposes.

a. There is very little authority on this issue, but the one case that analyzed this question, *Mattie Carter Trust*, reached a contrary result.

b. PLR 201317010 dealt with material participation in the context of the ever popular AMT adjustment to research and experimental expenditures (§ 56(b) for you home gamers), but the issue of material participation by trusts may be far more important for purposes of the newly added 3.8 percent Medicare Tax on net investment income. Passive activity income is treated as net investment income under § 1411 and, hence, subject to the tax if dollar thresholds are met. It is common for entrepreneurs to establish trusts to hold stock in family businesses for the benefit of children and grandchildren, both for estate planning purposes and to protect the beneficiaries from creditors or grasping no-good spouses. Prior to 2013 (when § 1411 first takes effect), practitioners may not have much cared whether a trust's share of income from the family business was passive activity income, or may have preferred that to be the case. The advent of § 1411 changes the calculus and, like an impending trip to the gallows, the possible imposition of a new tax has been known to "concentrate the mind;" since it is hardly clear that the IRS position is correct, expect further litigation or possible legislation on this issue.

10. Own any Bitcoins? No? As they say in the neighborhood, you may want to "get you some." Don't even know what Bitcoins are? Simple, Bitcoins are a peer-to-peer virtual currency created by a somewhat complicated process known as "Bitcoin mining" that is supposed to continue until 21 million Bitcoins have been created. (In case you are keeping score, we're more than half way there.)

    a. Some folks believe Bitcoins to be safer than, say, Euro's, Yen or Turkish Lira, for example. Others applaud the fact that some individuals, entities and businesses already accept Bitcoins in payment for goods and services. Still others like the fact that a government can't devalue Bitcoins or that they can't be lost in a bank failure. And many find the fact that Bitcoins can be transferred anonymously and internationally to be positively alluring.

    b. With the growing popularity and acceptance of Bitcoins, Treasury felt compelled to provide some guidance as to the applicability of the Bank Secrecy Act regulations to users of virtual currencies. Thus, the Financial Crimes Enforcement Network issued its initial advice on March 18 of this year.

    c. Are the principles of tax law applicable to Bitcoins clear? Well, in some important respects, one would think so. For example, the receipt of Bitcoins in exchange for the performance of services or sale of goods should result in income under § 61. And, presumably, an investor's sale of Bitcoins at a gain will be taxed as a capital gain. (Is this clear?) But more difficult issues may arise in the future, assuming Bitcoins survive. Stay tuned.

11. A district court ruled in September that the Code's confidentiality provisions with respect to tax information did not prevent IRS from using information derived in the audit of a taxpayer's return in an FBAR investigation. The audit revealed the taxpayer's use of foreign bank accounts for his online gambling pursuits.

12. A number of familiar tax provisions are scheduled to expire at the end of this year, and it is not known at this time whether any or all of them will be revived for 2014 and subsequent years.

Among the provisions set to expire are the optional sales tax itemized deduction; the $100,000 tax-free distribution to charities by the IRA's of older taxpayers; the above-the-line deduction for certain higher education expenses; 50 percent first-year bonus depreciation; the $500,000 limit on expensing under § 179; 15-year depreciation for qualified leasehold improvements; and principal residence mortgage debt forgiveness relief under § 108(a)(1)(E).

a. Given October's shutdown of the government, there's no telling how amusing the ongoing budget negotiations will be. Perhaps those negotiations will result in the preservation of some or all of these expiring provisions.

13. For several years now, we have reported in these materials and discussed in our seminars the issue of whether severance payments are wages for FICA purposes. We have recommended that practitioners advise clients to file protective refund claims with respect to this issue, since despite its loss in the *Quality Stores* case, IRS continued to argue, essentially, that the term "wages" should be defined the same way for FICA purposes as for income tax withholding purposes. Clients now have one last opportunity to file protective claims, as the Supreme Court has decided to hear the case in order to resolve a split in the Circuit Courts on this issue. (The Federal Circuit in the *CSX Corp.* case adopted the IRS' position.) Approximately $1 billion in refund claims are being held pending the Supreme Court's decision, expected next year.

14. Valuation issues in estate tax deficiency cases are fairly common, but some cases are more interesting than others.

a. IRS has asserted deficiencies and penalties aggregating more than $700 million against the Estate of Michael Jackson. The Service valued Michael's Bentley Arnage at $250,000, even though it's a used car that just happened to have been driven by the King of Pop. Far more interesting is the dispute over the value of Michael's "image and likeness." The IRS estimated that value at about $435 million; the estate returned it at $2,105. Much of the dispute centers on what the assets were worth at the time of Jackson's death, not thereafter, according to the estate.

b. But the case to really watch involves the Estate of William M. Davidson,[1] the owner of the Detroit Pistons NBA basketball team and an exceptionally successful entrepreneur. The IRS is seeking gift taxes and penalties of $885 million and estate and GST taxes and penalties of $1.8 billion. Although there are numerous issues in this matter, gifts involving self-cancelling installment notes and the valuation of interests in closely held businesses are the critical issues. According to Steve Leimberg, the IRS would, if completely successful in this one case, collect approximately 10 percent of the estimated total wealth transfer tax receipts for the year.

15. The Tax Court held in *John Hancock Insurance Co.* that the insurer's "lease-in, lease out" and "sale-in, lease out" transactions were not leases. Although the court concluded that the deals did not lack economic substance, it concluded that the true substance of the deals was a loan and that the taxpayer never acquired a leasehold interest or ownership interest in the assets.

1 I am indebted to my friend and partner, David Glyn, for calling this case to my attention.

16. In a taxpayer friendly development, the IRS announced in late October that participants in a health care flexible spending account plan could carry over up to $500 of their account balances into next year. This pronouncement mitigates the inflexibility of the "use it or lose it" principles that apply to FSA's. The change is effective immediately. Readers will recall that the Affordable Care Act limits health care FSA contributions to $2,500 per year.

17. In CCA 201343021, the IRS reaffirmed the position of Rev. Rul. 85-13 that the grantor of a grantor trust is not merely taxable on the trust's income but is, rather, treated for tax purposes as the owner of the assets of the grantor trust. The application of this principle resulted in the disallowance under § 267 and § 707 of losses on the sale of assets by an LLC to three trusts. The LLC was itself owned by a number of trusts whose beneficiaries were a father, his children, grandchildren and his own father; the purchasing trusts were grantor trusts of the father's children. The CCA is worth reading for a number of reasons, including the analysis used by the revenue agent to apportion interests in the LLC to the beneficiaries of the trusts that owned the LLC interests.

18. Want to know how well off you are tax-wise? The following puts things in some perspective. Yahoo! Finance reported on May 20 that according to the French business newspaper, *Les Echos*, more than 8,000 French households' 2012 tax bills exceeded 100 percent of their income. A further 9,910 households paid an astounding tax of more than 85 percent! *Les Echos* attributed this phenomenon to a one-off levy imposed on households with assets of more than 1.3 million euros. Previously, a "tax shield" capped an individual's overall tax rate at 50 percent.

19. In a case of local interest, District Court Judge Pratter ruled that Fannie Mae and Freddie Mac are exempt from realty transfer taxes, despite arguments to the contrary from Delaware and Chester Counties. Fannie and Freddie have won the majority of cases on this issue that have been decided in other jurisdictions.

20. In *Burroughs v. Abrahamson*, a taxpayer claimed that a female IRS revenue agent propositioned him during an audit and then threatened him with penalties if he didn't accede to her demands. Unlike Joseph of biblical times, who spurned the advances of his master, Potiphar's wife (Genesis 39:8-9), our hero "went along to get along," but subsequently sued the agent and the IRS. The complaint was dismissed for failure to demonstrate that the agent's actions were within the scope of her employment. In other words, screwing taxpayers wasn't part of the job.

    a. I had pretty much decided not to write that last line, and leave it to your imagination, but then I thought, Oh, what the hell.

    b. Folks, you can't make this stuff up. God help me, but I love the law.

21. In a very recent decision, *Freedom from Religion Foundation v. Lew,* a District Court held the parsonage allowance of § 107(2) unconstitutional. An appeal is expected.

22. And to end this section of the materials on a "high" note, the Justice Department announced in August that the administration had decided not to sue Colorado and Washington over their allowing the sale of recreational marijuana. Recreational marijuana use had been approved in elections in these two states. Righteous!

D. The Rogues' Gallery – 2013.

1. The IRS has announced that more than 38,000 taxpayers have entered the Offshore Voluntary Disclosure Initiative and paid more than $5 billion (so far) in penalties and back taxes. More than 120 taxpayers and advisers have been indicted. Expect these numbers to grow as the result of a recent agreement between the United States and a number of Swiss banks in which prosecution will be avoided or deferred if the banks disclose the identities of U.S. accountholders.

    a. Among those indicted, H. Ty Warner, the ultra-wealthy creator of "Beanie Babies." Old Ty must have sold a boatload of Beanie Babies, because he pled guilty in October to evading taxes on income from secret Swiss bank accounts in which he deposited more than $100 million. Needless to say, he didn't file FBARs. Warner, who is 69 years old, will be sentenced in January to a federal facility in which he'll likely meet an entirely different breed of "babies."

2. Some say crime doesn't pay, but consider the curious case of Bradley Birkenfeld. If that name sounds familiar, it should, because Brad was the affable but driven UBS banker who conspired to show so many Americans how easy it was to open hidden offshore accounts. Prior to being indicted, Birkenfeld went to the Justice Department in 2007 to reveal the whole sordid scheme at UBS. Because of the value and extent of his cooperation, prosecutors recommended a below guidelines 30 months in prison; the judge, unmoved, sentenced him to 40 months.

    a. But the story doesn't end there. In September 2012, the IRS awarded Birkenfeld a $104 million whistleblower reward, still believed to be the largest payout in U.S. history.

3. Mary Estelle Curran, a 79-year old widow living in Palm Beach, Fla., pleaded to failing to disclose a $43 million UBS account that her deceased husband originally established. The FBAR penalties were half of that amount. She tried to participate in the OVDI program, but was ineligible. Some zealous prosecutor concluded that it was in the interest of the United States to prosecute Ms. Curran who, by all accounts, knew nothing about the tax rules and little about financial matters. She was sentenced to a year of probation, but the judge immediately revoked the sentence and urged the Justice Department to join with her in seeking a presidential pardon.

    a. Why would the government bring a case like this in the criminal courts? As they say on the Monday Night Football pre-game show, "aw c'mon, Man!"

4. A brief review of the sentence in many of the undisclosed offshore account cases reveals that three years' probation (as well as various fines) seems to be a common sentence, but Kenneth Heller, a disbarred maritime lawyer, was sentenced to 45 days in prison after pleading guilty to hiding $26 million in an account at UBS and then moving it to Wegelin Bank before UBS disclosed the names of some 4,000 account holders to IRS. Heller was 82 years old when sentenced.

    a. Apparently, maritime law is a most lucrative practice area.

5. A report that appeared in Bloomberg News on October 31 stated that "thousands" of federal employees and contractors approved for security clearances from 2006 to 2011 owed $85 million in unpaid federal taxes, according to a GAO analysis. Senator Tom Coburn, the ranking Republican Senator in the Homeland Security Committee, was quoted as saying that "Federal tax cheats with security clearances are double threats that (sic) jeopardize both our national and economic security."

a. So owing taxes is not patriotic but very American.

6. Paul Daugerdas, a former tax partner at the now defunct Jenkens & Gilchrist law firm who devised a number of abusive tax shelter schemes that allegedly created $7 billion in fraudulent deductions, was convicted of tax fraud in a re-trial, but former BDO Seidman CEO Denis Field was acquitted. Both men had originally been convicted in a 2011 trial.

7. Famed singer Dionne Warwick filed for Chapter 7 bankruptcy protection in March, listing large tax debts she blamed on financial mismanagement. Warwick reportedly made several offers in compromise and requests for installment payment agreements but was turned down each time, according to her spokesman. Even the Psychic Network was, I suppose, unable to forewarn her of tax danger.

   a. Warwick's numerous hits are unlikely to be covered by, say, AC/DC or Black Sabbath – let's face it, they are a little "cheesy" – but they were good time tunes that made you feel better when you heard them. So I say a little prayer for Dionne Warwick and, if you see her walking down the street, and she starts to cry, each time you meet, ask the IRS why do they have to be a heartbreaker.

8. Singer Lauryn Hill, a member of the Fugees, was recently released from three months in jail for evading taxes on $1.8 million she earned between 2005 and 2007. Ms. Hill is from South Orange, N.J., which is not particularly noteworthy except that Dionne Warwick is from East Orange, N.J. What the hell is going on in the Oranges?

9. But tax crimes are not confined to the United States. Certain international celebrities have succumbed to the temptation of evade taxes, to wit:

   a. Lionel Messi of FC Barcelona fame, number 10 in your program but number one in your hearts, recently paid Spanish tax authorities 10 million euros to "correct" his tax situation for 2010 and 2011. He is also the subject of a judicial probe for 2007-09. According to a complaint filed by the Public Prosecutor, Messi "routed" endorsement income through companies in the UK, Switzerland and on to Uruguay. (Messi is from Argentina.)

   b. Steffano Gabbana and Domenico Dolce, famous Italian fashion designers, were sentenced to 20 months in jail for hiding millions of euros from Italian tax authorities through the use of a Luxembourg company. They were also fined 400 million euros. The two are appealing, and the designers were so offended when a city councilman referred to them as tax evaders, they temporarily closed their Dolce & Gabbana stores in Milan.

10. But my favorite international tale is that of Gregory Lepsveridze (stage name "Gregory Leps"), a Russian pop star who has been awarded the Russian Artist of Merit title, who was honored by President Putin for his "special energy," but who has been named a money courier for the international crime syndicate known as the Brothers' Circle, according to the U.S. Treasury Department. U.S. citizens are prohibited from engaging in transactions with persons so identified. On his website, Leps posted as follows (according to Bloomberg): "If Treasury executives think I'm a criminal, they should dig up Frank Sinatra and send him to jail. That's as absurd as the charges against me."

11. Despite the worthies whose efforts are outlined above, the "Worst Taxpayer of the Year Award" for 2013 goes to local favorite, Freddie Mitchell, former wide receiver for your Philadelphia Eagles. Mitchell who, during his largely unsuccessful NFL career, styled himself "FredEx," was sentenced in October to 37 months in jail for taking part in a bizarre tax fraud scheme. Seems Mitchell and his two co-conspirators filed a patently bogus tax return in the name of former NBA player, Drew Gooden (who knew nothing about all of this), collecting a $2 million refund in Gooden's name. The scheme unraveled when Gooden subsequently filed his own, correct tax return. At sentencing, Freddie's attorneys asked for leniency, claiming old FredEx had during his career suffered concussions which affected his current behavior, although in your author's judgment, he hardly caught enough passes in an Eagles uniform to be hit all that many times.

    a. Mitchell is best known for having caught the now legendary "fourth-and-26" pass in a 2004 playoff game at the Linc against the Green Bay Packers. When asked about the catch, Freddie famously "thanked his hands." Clearly, he could not have thanked his brains.

    b. So for concocting one of the stupidest schemes in tax fraud history, for blaming his troubles on phantom concussions and, most of all, for being a wasted first round pick who contributed little to the fortunes of the Birds, Freddie Mitchell wins our Worst Taxpayer of the Year Award for 2013.

And now, my friends, as we look forward during this season of miracles to the renewal of Congressional debate on the budget and the debt ceiling (known around here as the "From Hunger Games"), I leave you with my favorite belief, namely that "the best things in life aren't things."

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

Dennis Cohen