

# Maine Tax Forum 2012

## Federal Income Tax Case Law Developments

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# Significant Federal Tax Cases (2012)

There have been many tax cases decided by the federal courts over the past twelve months. I have chosen 10 cases to discuss today. I am hopeful that these selected cases are applicable and helpful to the practices of the audience members.

I begin with a summary list of the cases and then a separate slide for each case.

# List of 10 Cases

1. *Trout Ranch LLC v. Commissioner*, 10<sup>th</sup> Circuit (August 16, 2012) – valuation of conservation easement; use of post-transfer date information.
2. *Maguire v. Commissioner*, Tax Court (June 6, 2012) – S corporation basis; distribution from one S corporation contributed to a second related S corporation to create stock basis.
3. *Kaufman v. Shulman*, 1<sup>st</sup> Circuit (July 19, 2012) – Court rejects the Service's interpretation of Regulations concerning façade easements.

# List of 10 Cases

4. *Taproot Administrative Services, Inc. v. Commissioner*, 9<sup>th</sup> Circuit (March 21, 2012) – IRA cannot be an S corporation shareholder.
5. *Dorrance v. U.S.*, Arizona District Court (July 9, 2012) – insurance company demutualization; stock received has some basis.
6. *Calloway v. Commissioner*, 11<sup>th</sup> Circuit (August 23, 2012) - Purported stock loan recharacterized as sale transaction.
7. *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 7<sup>th</sup> Circuit (May 17, 2012) - consulting fees paid to founders of accounting firm held to be dividends.

## List of 10 Cases

8. *Peco Foods, Inc. v. Commissioner*, Tax Court (January 17, 2012) – buyer cannot change negotiated purchase price allocation.
9. *Historic Boardwalk Hall LLC v. Commissioner*, 3d Circuit (August 27, 2012) – Pitney Bowes found not to be a “bona fide member” eligible for allocation of tax credits by LLC.
10. *Barnes v. Commissioner*, Tax Court (March 21, 2012) – S corporation shareholder required to take all losses in the year incurred including suspended losses from prior years.

# Trout Ranch LLC v. Commissioner

**FACTS:** LLC purchased land and water rights. LLC donated a conservation easement to a land trust that encumbered 384 acres and entered into a conservation covenant with the county that encumbered 4 acres. LLC planned to develop the remaining LLC land. LLC claimed \$2 million charitable contribution for the grant of the conservation easement.

**ISSUE:** Did the Tax Court properly value the charitable contribution?

**HOLDING:** The Tax Court appropriately used pre-transfer data and post-transfer data to determine the value of the charitable contribution arising from the conservation easement.

# Maguire v. Commissioner

**FACTS:** Four taxpayers owned all of the stock of two S corporations. One corporation operated a car dealership and other corporation operated a finance company. The finance company operated at a profit and the dealership operated at a loss. The shareholders did not have sufficient bases in their dealership stock to deduct its losses, but they had substantial bases in the finance company stock. During the years in question, the finance company made distributions to the shareholders and the shareholders contributed these amounts to the car dealership to create basis against which to take the deductions.

**ISSUE:** Did the contributions by the shareholders increase their S corporation stock basis?

**HOLDING:** The shareholders can receive a distribution from one S corporation and contribute these amounts into a related S corporation to create basis against which to take deductions.

# Kaufman v. Shulman

**FACTS:** Taxpayer donated a façade easement restricting alterations to her Boston home to the National Architectural Trust. Code Sec. 170(h) requires that the easement be granted “in perpetuity.” In the taxpayer’s agreement with her mortgage lender, the lender subordinated its rights in the Boston home to the Trust to enforce the conservation and preservation purposes, but the lender maintained its prior claim to insurance proceeds arising from a casualty to the home.

**ISSUE:** Did the lender’s preserved right to the insurance proceeds from a casualty affect the “perpetuity” of the easement?

**HOLDING:** The Court rejected the Service’s interpretation of the Regulations that the lender’s position violated the requirement that the easement be granted in “perpetuity.”



# Taproot Administrative Services, Inc. v. Commissioner

**FACTS:** A taxpayer formed a corporation. The corporation issued all of its stock to a custodial IRA for the benefit of the taxpayer and the shareholder made an S corporation election.

**ISSUE:** Whether the IRA is an eligible S corporation shareholder?

**HOLDING:** Neither a regular nor a custodial IRA is an eligible S corporation shareholder. This is a case of first impression. Although an ESOP is an eligible shareholder, the Court agreed with the Service that an IRA is not an eligible S corporation shareholder. The taxpayer argued that a custodial IRA is an eligible shareholder because the custodial account is a mere agent for the taxpayer.

# Dorrance v. U.S.

**FACTS:** The taxpayer formed an irrevocable trust that purchased life insurance policies on the life of the taxpayer. The policies were purchased from mutual insurance companies. The insurance companies “demutualized” and issued non-voting stock to the trust. The trust sold the stock and reported all of the proceeds as gain. Later the trust filed a refund claim stating that the gain should have been reduced by the amount of premiums paid to the insurance company under the “open transaction” doctrine.

**ISSUE:** What is the basis of the stock held by the trust?

**HOLDING:** Court disagreed with the taxpayer’s argument that the “open transaction” doctrine applied. However, the Court agreed that the trust had some basis in the stock because the premium payments covered both policy rights and mutual rights.

# Calloway v. Commissioner

**FACTS:** Taxpayer owned publicly traded stock with a high value and a low basis. The taxpayer borrowed 90% of the value of the stock from the lender and used the stock as security for the loan. The lender had no restrictions on the use of the stock. At the end of the term of the loan, the taxpayer could pay off the loan and take back the stock, surrender the stock, or refinance the loan. During the term of the loan, dividends were paid on the stock. At the end of the term of the loan, the taxpayer surrendered his stock to the lender. Taxpayer never reported any dividend income or gain.

**ISSUE:** Whether the transaction is a loan or sale?

**HOLDING:** The transaction is a sale. The lender held all of the “benefits and burdens” of ownership of the stock from the date that the taxpayer transferred the stock to the lender as collateral.

# Mulcahy et al. v. Commissioner

**FACTS:** The accounting firm made payments to entities formed by its founders. The firm reported and deducted these payments as “consulting fees.” The Service reclassified these fees as dividends.

**ISSUE:** Whether the payments are deductible fees or non-deductible dividends?

**HOLDING:** The payments were non-deductible dividends. The Court rejected the firm’s argument that the payments were “hidden” payments to the founders for administrative services rendered. Rather, the Court found that the payments were “compensation for capital” and therefore dividends.

# Peco Foods, Inc. v. Commissioner

**FACTS:** Taxpayer purchased two poultry processing plants. With respect to each transaction, the taxpayer entered into a purchase and sale agreement with the seller in which the purchase price was allocated to the assets. After the completion of the purchases, the taxpayer hired a company to complete a cost segregation study of the purchased assets. Based upon this study, the taxpayer requested a change in accounting method to change the classification of some of the assets. This change increased the amount of depreciation deduction with respect to those assets.

**ISSUE:** Whether the Service properly denied the request to change the accounting method.

**HOLDING:** The two transactions were “applicable assets transactions” under Code Sec. 1060(c)(1) and therefore the taxpayer was bound by the purchase price allocation in the negotiated purchase and sale agreement.

# Historic Boardwalk Hall LLC v. Commissioner

**FACTS:** Pitney Bowes was a member of an LLC created to rehabilitate a landmark on the boardwalk of Atlantic City. The LLC received rehabilitation tax credits and allocated the credits to its members, including Pitney Bowes. The Service found that Pitney Bowes was not a bona fide member eligible for an allocation of the credits.

**ISSUE:** Whether Pitney Bowes was a member of the LLC?

**HOLDING:** No, Pitney Bowes was not a member of the LLC. The Court found that Pitney Bowes did not have any downside risk or upside potential in the enterprise of the LLC and therefore was not a member for tax purposes.

# Barnes v. Commissioner

**FACTS:** Taxpayer owned stock in an S corporation. In 1997, Taxpayer did not deduct all available losses. His basis in his stock reflected a reduction only for the amounts actually taken. In 2003, the S corporation had a significant loss and the taxpayer reported all of his share of the loss. The Service denied the deductions stating that the taxpayer did not have sufficient tax basis to cover the amount of the deductions.

**ISSUE:** Must the S corporation stock tax basis be reduced for deductions actually taken or for all losses that should be taken?

**HOLDING:** Under Code Sec. 1366(a)(1), the stock tax basis must be reduced by all losses that can be taken. The basis reduction rule is not limited to losses that are actually claimed.