In news analysis, Lee A. Sheppard discusses the revamped Circular 230, and says some proactive tax practitioners feel that the rules are being unfairly changed in the middle of the game.

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Readers responded so positively to the handbag discussion in our recent estate tax article that we have to have more fashion coverage. One reader's wife, who is not even a tax professional, passed around the handbag essay.

So let's talk about Kate Moss.

Moss was famously fired from lucrative advertising contracts with H&M, Chanel, and Burberry after being photographed snorting cocaine by a British tabloid. She still has advertising contracts with Dior, Gloria Vanderbilt jeans, and British cosmetics company Rimmel. That's a lot of contracts to have, indicating that Moss must be an effective selling tool.

"Model Does Cocaine" is no more of a headline than "Dog Bites Man" is. "Model Shows Up on Time for Work, Straight and Well-Rested" -- that would be news. A fashion industry adage is that fashion models' four food groups are cocaine, champagne, coffee, and cigarettes.

The fashion world is famously tolerant of recreational substances unless they impede job performance. Moss, who like most models is a heavy smoker, has been in rehab for alcohol, and nobody thought a thing of it. Seems that Johnny Depp's effect on women is such that every woman who breaks up with him winds up in a hospital.

Oh, but didn't Moss's contracts, like all advertising contracts, contain a discretionary clean-living clause? That clause mostly means "be discreet." Models are not required to pee in cups before shoots. Besides, a case can be made that the advertisers hired Moss precisely because she frequently looks like she is in need of a bath.

The advertisers hired Moss because she is hip, edgy, and influences young people's fashion choices. A product of Croydon, a working-class south London neighborhood, Moss epitomizes London street style, with her unschooled, offbeat choices and combinations. She single-handedly revived the Hermès Birkin bag, hitherto an old-ladyish accessory. So the 31-year-old who looks 15 was expected to do the same for Chanel perfumes and Burberry raincoats. Ironically, it was a complaint to H&M, purveyor of cheap copies of designer clothes to teenagers, that sparked the contract revocations.

Oh, but Kate Moss shouldn't take cocaine because she is a mother. Moss can afford to be irresponsible. She has enough money to hire a responsible individual to take care of her child. Her case is not comparable to that of the legions of crystal meth addicts in America whose neglected children have overwhelmed state agencies and charities. Money does change everything.

Like coke-snorting models, some proactive tax practitioners feel that the rules are being unfairly changed in the middle of the game. The object of their complaints is the revamped Circular 230, which has teeth supplied by the American Jobs Creation Act of 2004 (P.L. 108-357). Some prominent practitioners gathered at the Practising Law Institute (PLI) seminar on tax aspects of mergers and acquisitions on September 30 to complain that their practices should not be subject to the full force of the revamped Circular 230.

IRS Chief Counsel Donald Korb, who was on the PLI panel, couldn't tell those practitioners that their big-money corporate deals aren't tax shelters, but that is the reassurance they want. Nor could he give the green light to their solicitation of clients with new tax planning ideas by passing opinions around, regardless of the merits of those ideas, at least not without complying with the full panoply of requirements of Circular 230.

That is because of the definition of marketing in the final Circular 230. A marketed opinion is a subset of covered opinion. A marketed opinion concerns a listed transaction or any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax. But the definition of "marketing" is narrow -- it only applies to marketing by third parties, not self-marketing. A practitioner giving a covered opinion cannot assume that a transaction has a business purpose, that it is potentially profitable, or make any assumption about a material valuation question.

As a practical matter, the narrow definition of marketed opinion means that Wall Street law firms can't give hypothetical opinions to investment banks to pass around. So when David Hariton of Sullivan & Cromwell asked whether law firms could solicit potential clients about contingent convertibles (securities that produce an overstated interest deduction that have been blessed by the government), Korb responded that they could not, at least not without their missives being covered opinions.
"I wouldn't do that in this environment," Korb said, indicating that Hariton was overstating the case. "The point is the expression" of the tax idea, he said.

Asked by B. John Williams of Shearman & Sterling whether local standards of practice would influence the decisions of the new IRS Office of Professional Responsibility (OPR), Korb could not answer. "We're entering a new world," he said, noting that Circular 230 was "a federal overlay" to existing state regulations. He reassured his audience that the chief counsel's office would be involved in OPR cases, as the office is in discussions to request tax accrual workpapers.

Now Get Outta Here

Well, gee, why is this news? The final version of Circular 230 has been out for nearly a year, and the government's lenient attitude toward corporate transactions practice remains unchanged. However, a couple of recent court opinions have taken all the fun out of some practitioners' lives. For starters, the coat-and-tie crowd who never imagined that they could be subject to tax penalties had some whopping penalties upheld by the Second Circuit in Long Term Capital Holdings LP et al. v. United States, No. 04-5687 (Sept. 27, 2005), Doc 2005-19826 [PDF] or 2005 TNT 187-16 (2).

The Long Term Capital Holdings (LTCH) decision came a scant week after oral arguments in Manhattan in which the taxpayers, with new representation, appealed only the penalties. The taxpayers argued that they were being punished for the misdeeds of their advisers. The court was nonplussed that the latter could assume profit motive and business purpose. (For coverage, see Doc 2005-19498 [PDF] or 2005 TNT 184-1 (2).)

In its terse per curiam opinion, the court noted that the district court found no evidence that the taxpayer received the oral opinion that it claimed to have relied on before filing its return, and even if it had, the later documentation of that opinion was not based on all pertinent facts and circumstances. The taxpayer, the court said, knew that the assumptions of business purpose and profit motive were false. The taxpayer also knew that the assertion that there was no prior agreement to have the partnership interest redeemed was false. (For description of the transactions, see Doc 2004-17569 [PDF] or 2005 TNT 173-5 (2).) As to the application of the step transaction doctrine, the court noted that even if the partnership had some economic effect, application was not precluded.

Well, gee, LTCH was a tax shelter, and acquisitive corporate reorganizations cannot possibly be tax shelters, can they? The corporate bar is also feeling the pain from the Tax Court's recent opinion in Tribune Company et al. v. Commissioner, 135 T.C. No. 8, No. 17443-02 (Sept. 27, 2005), Doc 2005-19801 [PDF] or 2005 TNT 187-12 (2). Adding to their distress was that the judge in that case was Tax Court Judge Mary Ann Cohen, who decided Esmark Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989), which the bar has read to mean do anything you want in subchapter C.

Times Mirror Co., the predecessor of the taxpayer, used a limited liability company as a vehicle for the sale of its Matthew Bender legal publishing subsidiary. The LLC had been created by the purchaser, Reed Elsevier. Its sole initial member was a Reed Elsevier special-purpose subsidiary that had a second-tier merger subsidiary. Capitalized with cash equal to the purchase price, the merger subsidiary bought the shares of the special-purpose subsidiary, which then contributed the cash to the LLC.

The merger subsidiary exchanged the shares for Matthew Bender shares in a reverse triangular merger in which Matthew Bender survived. That'd be clean, except that Times Mirror wanted cash. After becoming the controlling shareholder of the special-purpose subsidiary, Times Mirror became sole manager of the LLC, despite having no direct equity interest in it. The LLC then proceeded to use its considerable cash to purchase Times Mirror shares. The LLC was consolidated with Times Mirror for financial accounting. Times Mirror retained a tiny indirect interest in Matthew Bender, and Reed Elsevier retained shares in the special-purpose subsidiary. (For discussion, see Tax Notes, Jan. 4, 1999, p. 32.)

The question was whether the law should respect the form of the reorganization or follow the cash. When the dust cleared, Times Mirror had $1.375 billion in cash in an LLC that it solely managed. Voting control of Matthew Bender was separated from economic growth, so that while the vote remained with seller Times Mirror, the growth potential went to purchaser Reed Elsevier. The merger of the subsidiary into Matthew Bender was supposed to qualify as a tax-free statutory merger under code sections 368(a)(1)(A) and (a)(2)(E) provided the tax administrator ignored the surrounding circumstances, chief among them that pile of cash that ended up in Times Mirror's control.

Staying within the parameters of the reorganization rules, the government argued that for the deal to qualify, the shares exchanged had to be roughly equal in value to those tendered. The taxpayer alternatively argued that the deal was a B reorganization, and the government countered that if so, it improperly included cash consideration in addition to share consideration. The court was agnostic about how many angels were dancing on the head of the section 368(a) characterization pin. The government acknowledged a taxpayer business purpose of selling, but argued that the substance of the deal was a swap of Matthew Bender for cash.

What the taxpayer told its own shareholders, board of directors, and the SEC made a difference to Judge Cohen. It told all of them that it had the LLC's cash free and clear. But the taxpayer made a Byrum-type argument that it lacked total control over the LLC because of fiduciary obligations to Reed Elsevier as the minority shareholder of the special-purpose subsidiary. The court couldn't
find any such obligations or restrictions on the use of the LLC's cash, $21 million of which it caused to be paid to itself as a dividend in the year after the sale. Judge Cohen concluded that the consideration received by Times Mirror was not shares but control over the cash.

The court brought the LLC control/cash in as additional nonqualifying consideration in the reorganization, but it nonetheless had to be demonstrated that the shares of the hollow special-purpose subsidiary weren't worth four times the value of the cash in the LLC. Readers, dueling experts actually stood around the court and valued the shares of the special-purpose subsidiary. We're not making this up. One expert even said they were worthless. The shares of the special-purpose subsidiary, Judge Cohen concluded, did not have sufficient value to carry the deal.

In *The Falconwood Corporation v. United States*, No. 04- 5111 (Sept. 2, 2005), Doc 2005-18305 [PDF] or 2005 TNT 171-52, the Federal Circuit refused to apply the step transaction doctrine in the face of an exceptionally formal consolidated return regulation that said when the group should continue to exist. That was basically a case like *Woods Investment Company v. Commissioner*, 85 T.C. 274 (1985), 85 TNT 163-22, and the government shouldn't have been in court arguing against its own regulation. (CC-2002-43, Doc 2002-23942 [PDF] or 2002 TNT 206-13.)

(*Falconwood* involved an affiliated group, owned by an individual, that filed a consolidated return. The group's parent merged into a subsidiary, and the question was whether the group continued to exist for three hours before its conversion to a set of S corporations owned by the individual so that it could include losses of its predecessor group on its final consolidated return. The pertinent regulation, section 1.1502-75(d)(2)(ii), states that a filing group shall be considered to remain in existence, despite the parent no longer existing, if group members succeed to the former parent's assets and an existing member becomes the new parent. (See also reg. section 1.1502-76(b)(1).)

At the trial level, *Falconwood* had been decided in the government's favor, on cross-motions for summary judgment, on the grounds that three hours was not enough time to be considered to remain in existence under reg. section 1.1502-75(d)(2)(ii), even though the tax law tolerates short tax years interrupted by reorganizations. The government could not say how much time would be enough, only that three hours was not.

Tosh, said the Federal Circuit. "We cannot agree that there is any principled difference between the three-hour time period in this case and the passage of days or weeks or months in some other case where there could be no reasonable doubt about the satisfaction of the 'there remains' test," Circuit Judge Diane Gilbert Sypolt wrote. The court applied the regulation literally, noting that it required consolidated filing for a group deemed to remain in existence. The court reminded the government that it could rewrite its regulations.

What about the step transaction doctrine? Shouldn't the group have been deemed to have just converted to a bunch of commonly owned S corporations? The business purpose of the seemingly extraneous step, the downstream merger, was to avoid regulatory hassles about transferring the seats on the exchanges that the corporations, which traded commodities, individually held. That was enough to satisfy the court that the three-hour filing group should be respected.

Nonetheless, in what appears to have been *dicta*, Judge Sypolt showed some skepticism about the importance of a requirement of a business purpose to validate extraneous steps. "In light of existing case law, what is less clear is the weight to be given that independent purpose in determining whether to ignore for tax purposes certain steps" in the taxpayer's rearrangement, Judge Sypolt wrote, noting that other circuits had made a hash of the step transaction doctrine.

Despite the extreme permissiveness of American consolidated filing rules, there was some griping about the *Falconwood* result at the PLI seminar. Andrew Dubroff of Ernst & Young insisted that there should be some substance to the group's existence and that it should have hung around for a day before conversion to S corporations. Bill Alexander, IRS associate chief counsel (corporate), disagreed with Dubroff's interpretation of the regulation. But he added that he hoped that the court "didn't mean" some of the bad things it said about the step transaction doctrine.

**Forthcoming Guidance**

Eric Solomon, Treasury's deputy assistant secretary for regulatory affairs, said that Treasury is willing to consider changes to the marketing definition and waiver provisions in Circular 230. He said that his office was working on section 6111 regulations covering material advisers. Among the difficult issues is the development of the loss and book/tax differential filters to determine whether an arrangement is a shelter.

Solomon promised PLI participants that regulations interpreting the section 199 manufacturing deduction would be out very soon. They have been drafted, and a darn good thing they have been, because they have been devouring government resources since the passage of the law. Solomon explained that among the questions addressed in the forthcoming package are the treatment of contract manufacturers, online software, allocation of costs, and attribution to a partnership that distributes a product made for it by a corporation. Solomon added that the recent energy bill and highway bill are chewing up government time because those bills have short fuses for guidance.
But despite his lofty position and admitted embrace of "wonkdom," Solomon would rather be toiling in subchapter C, in which he originally specialized. He promised that section 355 active trade or business regulations would be issued soon. Domestic and international specialists are hard at work on a massive package of final section 368 regulations that would permit domestic and cross-border mergers with tax nothings. That package currently takes the form of temporary domestic regulations and proposed international regulations.

The recently issued business plan has several weighty corporate and consolidated return projects. (See Doc 2005-16766 [PDF] or 2005 TNT 152-18.) Among them is guidance under section 336(e), for which the question is whether the privilege of a section 338(h)(10) election will be extended to noncorporate acquirers and members of affiliated groups. Some taxpayers take the position that they have that power already. At the PLI seminar, Alexander insisted that taxpayers cannot make that election in the absence of regulations, because it is not self-implementing. (For discussion of the issue, see Doc 2005-17673 [PDF] or 2005 TNT 172-22.)

Also on the list is revision of reg. section 1.1502-13(g) for cases in which intercompany obligations move around -- but not in or out of -- an affiliated group. Treasury attorney-adviser Audrey Nacamuli told PLI participants that the drafters were choosing between approaches that would refine the existing rules or only pay attention to location in cases of abuse. (See Announcement 2004-44, 2004-1 C.B. 957, Doc 2004-10942 [PDF] or 2004 TNT 100-13.) Of course, if intercompany obligations are to be recognized, cases in which an intercompany obligation might render an otherwise solvent member insolvent must be dealt with. That question is also on the business plan.

Other projects concern the definition of F reorganization and the interaction of section 362(e)(2) with the consolidated return rules. Section 362(e)(2) was a basis write-down rule enacted in the Jobs Act to combat a popular corporate shelter that achieved loss duplication in a section 351 transaction. (For discussion, see Doc 2005-11538 [PDF] or 2005 TNT 118-36.) That is not the section 302 basis-shifting shelter, for which the complicated rules proposed as a cure are being reexamined, according to Nacamuli.

In section 362, Congress gave the taxpayer an election to write down the basis of shares instead of contributed assets. Like any taxpayer election, this was not a good idea. What if, Solomon suggested, a taxpayer elected to write down share basis on the contribution of loss assets to a controlled subsidiary that was included in its consolidated return, then the subsidiary sold the assets at a loss? Would the taxpayer then have to reduce share basis further according to reg. section 1.1502-32, the investment basis adjustment rule?

A subsequent PLI panel struggled with that and other questions raised by the interaction of section 362(e)(2) with the consolidated return rules. Teresa Abell, IRS counsel to the associate chief counsel (corporate), said the taxpayer should not be required to reduce basis twice in Solomon's example. She and Nacamuli disagreed, however, on whether a section 362(e)(2)(C) elective reduction in share basis should tier up, requiring further share basis reduction under reg. section 1.1502-32, if the electing corporate owner of shares had a corporate parent above it with which it joined in a consolidated return. Abell would require further share basis reduction, while Nacamuli would not. That is why guidance is slow in coming.

Loss Disallowance

When we last visited the loss disallowance rules, IRS officials were dithering with an imprecise solution to the messy problem of disallowing duplicated loss. That'd be the "basis disconformity method."

In Notice 2004-58, 2004-2 C.B. 520, Doc 2004-17157 [PDF] or 2004 TNT 166-7, the IRS announced that it would accept the basis disconformity method for determining the extent to which loss could be attributed to built-in gain. The basis disconformity method presumes that any gain realized by the subsidiary on a disposition of an asset was built in when the subsidiary was acquired. That has the effect of counting all asset gains without asking when the asset was acquired.

Abell was on hand to discuss the government's planned backtracking on the basis disconformity method. The new method will not, however, be tracing. "You can't do it, and we can't audit it," Abell said of tracing. The new method will have presumptions, which will not be rebuttable, Abell said, because that would bring everyone right back to tracing.

The government is chuffed by the addition of the anti-Rite Aid amendment to section 1502 contained in the Jobs Act, which it believes reaffirms and strengthens the government's ability to act in the realm of consolidated returns.

Section 1502 now contains the following additional sentence: "In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." Abell said the government's belief is that this would allow it to make consolidated return rules differing from separate return rules when necessary to achieve clear reflection of income.

Abell speculated on the new method for forthcoming loss disallowance rules, which must be promulgated by the time the existing temporary regulations expire next March. The existing basis disconformity model takes account of all gains but no losses on asset sales. Under the new method, realized built-in loss would reduce realized built-in gain, so the calculation of realized asset gain
would be made at least partly on a net basis rather than gross. That is, the disallowed loss under the new method will probably be based on net built-in positive adjustments rather than on gross positive adjustments. The remaining issue here, Abell said, is treatment of postacquisition loss (and gain). The government does not want to cut off postacquisition items. A rule that allowed netting of all gains and losses would allow both pre- and postacquisition loss to reduce built-in gain.

That's what goes into the basic calculation. How big is the cap on disallowed loss? Should it be limited by the purchase price of the subsidiary, which is the maximum possible built-in gain? The basis disconformity method rears its head again here, because the cap that Abell said the government wants is the basis disconformity amount. The basis disconformity amount is the amount of the differential between the subsidiary's basis in all its assets and the parent's basis in the shares of the subsidiary. Abell believes that this cap would allow the maximum taxpayer entitlement to losses on subsidiary shares in excess of net built-in gain in subsidiary assets. She admitted that those losses would be duplicated in the subsidiary assets. Some duplication, apparently, is inevitable.

Ooh, and what happens if the taxpayer is simultaneously subject to the new loss disallowance rules and section 362(e)(2)? That would occur when a built-in loss asset contributed to a controlled corporation in a section 351 transaction appreciated in value, was sold, and the gain was reflected in an increase in the basis of the shares of the controlled corporation. Abell commented that basis reductions required by the latter would be backed out of the basis disconformity amount to determine whether loss should be disallowed on a subsequent sale of the shares of the controlled subsidiary.