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MEMORANDUM

Recent Developments Affecting Like-Kind Exchanges Under §1031

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Major References:

I.R.C. §1031.

We hailed 2004 as the "Year of §1031"³ because so many significant developments occurred last year. However, 2005 was no slouch either. As illustrated below, there were a number of interesting developments this year, with perhaps the biggest of all scheduled to come by the end of this month.

RELATED PARTY EXCHANGES

PLR 200440002

The IRS ruled that an exchange in which taxpayer AB acquired, through a Qualified Intermediary (QI) replacement Property X from related-party CD did not run afoul of the related party exchange limitations under §1031(f) because Property X served as CD's relinquished property in CD's own separate and distinct exchange (through CD's QI). The ruling distinguished Rev. Rul. 2002-83,⁴ on the ground that neither AB nor CD "cashed out" in overall transaction but rather continued their respective investments in real estate.

1. This is a significant departure from the analysis in Rev. Rul. 2002-83.
2. The instructions to Form 8824 were clarified to eliminate the bold statement that anytime replacement property is acquired from a related party through a QI, the exchange will be disqualified under §1031(f)(4).
3. This arguably provides for an extension of time to acquire replacement property. A taxpayer could, if necessary, do an exchange with a related entity and then that entity could do its own exchange for property the taxpayer wanted. This is why a related party property should always be identified as a third alternative property.

*Teruya Brothers, Ltd. v. Comr.*⁵

This case, which is a full Tax Court case (as opposed to a Memo decision), is the first case interpreting §1031(f). The case is significant because:

1. Contrary to prior IRS position, the IRS and the Court seemed to agree that for purposes of §1031(f)(1), the QI is not considered an agent of the taxpayer and that §1031(f)(1) applies only to direct related party exchanges. The IRS previously had said it can pick and choose between §1031(f)(1) and (f)(4).
2. The Court rejected the IRS's assertion that if an exchange would fail under §1031(f)(1) if it were recast as a direct exchange without the QI, it necessarily will fail under §1031(f)(4). This was similar to the statement in the instructions to the Form 8824, which interpreted Rev. Rul. 2002-83. This should eliminate any assertion that a related party exchange utilizing a QI will necessarily fail.
3. Exception in §1031(f)(2)(C) is subsumed in §1031(f)(4).
4. The taxpayer's counsel cited no explanation for utilizing a QI

or for the structuring of the transaction and the Court concluded that the exchange failed under §1031(f)(4). Taxpayer's argued, unpersuasively (according to the Court), that it is irrelevant what happens to the relinquished property as long as taxpayer continues its investment in like kind property.

5. There were arguments that perhaps could have been made, but were not:

a. The sale by Times (the related party) to the taxpayer resulted in a loss that was not recognized under §267, but would have been if sold outside the group.

b. If Times had sold both properties to unrelated parties, it would have had an overall loss (even without the use of a net operating loss (NOL) it had) which would not have been restricted by §267.

c. The fact that Times had losses to offset taxable gain on the taxable transfer still results in a real cost to it, since those losses could have been utilized to offset other income. On an overall basis, there was no tax avoidance benefit achieved by doing a related party type exchange (i.e., it did not derive a tax benefit that could not have been achieved if it had an actual related party exchange).

d. If taxpayer did not use a QI, the related party (i.e., Times) would have to sign a contract for the purchase of the relinquished property (and then a separate contract with the ultimate buyer) and treat itself for all purposes as having purchased and sold the property from the taxpayer. There might be a bank or business restriction on such action.

e. It was necessary for Times to sell its property to reduce a bank loan.

Related Party Leasehold Improvements -- Rev. Proc. 2004-51

Rev. Proc. 2004-516 clarified/confirmed that a taxpayer could not transfer (or presumably lease) its own land to an exchange accommodation titleholder (EAT), have the EAT construct improvements thereon, and then transfer it back to the taxpayer as replacement property in an exchange. The revenue procedure expressly left open the question (for further study) whether a related party could lease its land to the EAT; have the EAT construct improvements thereon; and transfer it back to the taxpayer as replacement property in an exchange. However, it is now clear that there likely is not to be any further rulings or revenue procedures on such related party leasehold improvement transaction. The IRS has appeared to accept this technique.

Two-Year Holding Period

Is the two year holding period of §1031(f)(1)(B) ever relevant when a QI is utilized (e.g., when relinquished property is sold to a related party through a QI and both the taxpayer and the related party hold onto their respective properties for two years)?

Section 1031(g)

How does §1031(g)(2)(B) serve to substantially diminish risk of the taxpayer when a third party merely has a right to acquire the property? How could an option held by a third

party diminish the taxpayer's risk? There is no guidance interpreting this provision.

DELAWARE SERIES LLC

Under Delaware law, an LLC can have different series with different properties in each series and different members having rights (or no rights) within each series. For §1031 purposes, if there is a transfer of a property in one of the series, is this a transfer by the series or by the LLC? Is the series an entity separate from the LLC? The IRS has initiated a National Office project, but it appears to be in limbo.

UNDIVIDED INTERESTS

Rev. Proc. 2000-467

The IRS studied under what circumstances undivided interests will be treated as partnership interests.

Rev. Proc. 2002-228 -- Culmination of Study

1. The guidance is in the form of 15 guidelines that have to be met in order to obtain *an advance ruling*. Very few rulings have been obtained.
2. On March 7, 2003, the IRS issued its first ruling under Rev. Proc. 2002-22.⁹ The IRS permitted generic form documents, with no specific property or investors, in violation of the revenue procedure. IRS also permitted (1) a sponsor to stay in as tenant-in-common (TIC) co-owner for at least up to 18 months, in order to sell all the interests, and (2) limited non affirmative consent to renewal of management agreement.
3. On December 6, 2004, the IRS issued its second ruling; this one involving a more typical blanket mortgage.¹⁰ IRS permitted (a) sponsor to stay in indefinitely as co-owner; (b) manager to have some discretion in leases; and (c) broader non affirmative consent to management renewal.

Current Practice and Likely Future Developments

1. Is the revenue procedure being ignored by practitioners?
2. Some of the California commercial office building and strip mall deals, which involve significant capital expenditures in the way of improvements or rehabilitation costs, as well as substantial leasing activities, may raise serious questions about partnership status. The staff of the Senate Finance Committee has indicated that they may look at some TIC deals to see if legislation (presumably restricting certain types of transactions) is warranted.
3. Effect of ownership through single member LLC's where the debt is not recourse to the underlying owner. This appears to be

a non-issue which has been perceived incorrectly by the industry as an impediment to requesting rulings.

4. What is the effect of so called "bad boy clauses?" This is more uncertain, but should not prevent a ruling where the triggering event (e.g., fraud) is clearly unanticipated and unlikely.

Non-Safe Harbor Reverse Exchanges

FAA 20050203F

In a controversial FAA, FAA 20050203F, the IRS analyzed a "non-safe-harbor" reverse exchange and concluded that the Accommodator lacked sufficient "burdens and benefits" of ownership to be respected as the tax owner of the "parked" replacement property. Based on case law in other areas, the IRS looked to:

1. Whether legal title passes.
2. Whether the parties treat the transaction as a sale.
3. Whether the purchaser acquires an equity interest in the property.
4. Whether the sales contract obligates the seller to execute and deliver a deed and obligates the purchaser to make payments.
5. Whether the purchaser is vested with the right of possession.
6. Whether the purchaser pays property taxes after the transaction.
7. Whether the purchaser bears the risk of economic loss or physical damage.
8. Whether the purchaser receives a profit from the property.

Some commentators thought this was a change from the position taken by the IRS in PLR 200111025, which upheld a non-safe harbor parking arrangement, despite the benefits and burdens of ownership arguably not being with the accommodator.

FASB 109 -- Accounting for Uncertain Tax Positions

The Initial Accounting Board recommendation to require "should" opinion would have been an impediment to these types of transactions. However, the recommendation recently was revised to require only a more likely than not opinion.

ADDITIONAL §1031 DEADLINE EXTENSIONS FOR DISASTER RELIEF PROPERTIES

Notice 2005-3¹¹ advises taxpayers that the IRS and Treasury Department will provide additional tax relief to taxpayers (transferors) involved in §1031 like-kind exchange transactions affected by a Presidentially declared disaster, a terroristic or military action, service in a combat zone, or service with respect to contingency operations.

FIRST RULINGS ON MAGNENSON/BOLKER ISSUE

PLR 200521002 and PLR 200528011 suggest an independence type test on distributions

from a trust just after a §1031 exchange, where the property was held in a single member LLC which was necessarily converted to a partnership for tax purposes on distribution to the beneficiaries.

1. This could have a significant effect on tax planning. Most practitioners would not recommend a subsequent transfer of replacement property into a partnership which occurred less than 12 months after the completion of the exchange, irrespective of whether an independence type test could be met.
2. Rulings seem to otherwise reaffirm prior IRS position.
3. Hopefully, there will be more rulings in the future. Note, e.g., that it is not clear the *Magnenson/Bolker* decisions would control even in the Ninth Circuit if the partnership were an LLC and/or the partnership were widely held and taxpayer's property was only one of many properties owned by the partnership (e.g., a transfer to an UPREIT).

SECTION 601 OF THE AMERICAN JOBS CREATION ACT (AJCA):12 PAYMENT FOR TOBACCO QUOTAS

1. Payments (by government) made over 15 years to holders of tobacco quotas. The right to receive payments can be assigned to financial institution for a lump sum payment.
2. Under Notice 2005-57,¹³ an owner may enter into a §1031 exchange of a quota. Liberal rules are allowed to meet requirements.

PROPOSED REGULATIONS ON NET VALUE IN REORGANIZATIONS

1. Prop. Regs. §1.368-1(f) provide that a tax free reorganization requires both the transferred property and the received property to have a net asset value.
2. The regulations under §1002 indicate that the non recognition provisions of the Code are to be strictly construed and have similar characteristics and objectives.¹⁴
3. Potential effect on §1031 (i.e., transfers to avoid gain on foreclosure)?

SECTION 840 OF AJCA: INTERACTION OF EXCLUSION OF GAIN ON SALE OF PRINCIPAL RESIDENCE AND LIKE-KIND EXCHANGES

Under §121(d)(10), effective for sale or exchanges occurring after October 22, 2004, gain realized on the sale of a principal residence that previously was acquired as replacement property in a §1031 exchange is not excluded from income under §121(a) if the sale

occurs within five years from the date the residence was acquired by the taxpayer.

REV. PROC. 2005-14: GUIDANCE ON THE APPLICATION OF §§121 AND 1031 TO A SINGLE EXCHANGE OF PROPERTY

Rev. Proc. 2005-14¹⁵ applies to Taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under §121 and the nonrecognition of gain on the exchange of like-kind property under §1031.

1. Section 121 is to be applied first, so that any cash received will only be treated as taxable boot §1031 to the extent it exceeds the gain excluded §121. There was a lot of uncertainty about this issue in the past.
2. As long as a former residence is investment property "at the time of the exchange," it will qualify under §1031. While the example in the revenue procedure involves a residence rented out for somewhat more than two years, the quoted language does not seem to require such a rental period.
3. Section 1031 will apply where only $\frac{1}{3}$ of a house (which constitutes a single dwelling unit) is used for business purposes, so that $\frac{1}{3}$ can be exchanged for a separate business property.
4. Rev. Proc. 2005-14 does not specifically relate to vacation home/§1031 issues.

COST SEGMENT STUDY -- EFFECT ON §1031

To what extent does a cost seg study result in property not qualifying as eligible replacement property for real estate? See PLR 200450005, which held that an SUV is like kind to a passenger automobile. This may provide support to the argument that positions taken for depreciation purposes are not relevant to §1031.

TEMPORARY REGULATIONS UNDER §1031

Regs. §1.1031(a)-2T(b)(3) substitutes six digit product class within NAICS for four digit SIC Codes (relevant to personal property exchanges).

PLR 200541037

The IRS ruled in PLR 200541037 that an exchange of old growth timber for reproduction timberlands is like kind.

REPORTING OF INTEREST

Regs. §1.468B-6 has been re-proposed. In all cases except where all of the interest earned from the exchange account is credited to the taxpayer, the exchange proceeds are treated as loaned to the taxpayer, with the result that §7872 applies as a compensation related loan. Under Prop. Regs. §1.7872-16, the general testing rate is the 182 day rate.

SECTION 470(e)(4)

Section 470(e)(4) provides that §1031 may not apply if the relinquished or replacement

property is tax exempt use property.

FCC LICENSES

In PLR 200035005, the IRS permitted an exchange of three FCC radio licenses in three different cities for an FCC television station license in a different city. This was a very generous and surprising ruling.

In PLR 200224004, a follow up to TAM 200035005, the IRS ruled that network affiliation agreements and goodwill are assets separate from FCC licenses for purposes of the exchange. The exchange of good will does not qualify (exchange of radio license for TV license is a problem because radio typically does not have network affiliation agreements). This is *now* on Coordinated Issue List.

In PLR 200532008, the IRS ruled on an exchange of rights within different spectrum bands. The IRS appears to have ruled that (1) all rights within the spectrum are like kind to each other, (2) generally all rights covered by copyrights generally are like kind to each other -- the first prong of the test --, and (3) the underlying property -- the second prong of the test -- is the entire electro magnetic spectrum. *Query how this can be reconciled with the regulation stating that a copyright in a song is not like kind to a copyright in a novel.*

OTHER INTANGIBLES -- TAM 200602034

1. For purposes of the second prong of the intangibles test in the regulations, taxpayer tried to group all patents, trademarks and unregistered intellectual property into several broad categories. In rejecting this approach, the National Office said that the like kind standard for intangibles is to be construed very narrowly, even more so than tangible personal property which is to be construed more narrowly than real estate. This is contrary to the recent TAM on licenses in the electro magnetic spectrum.

2. The National Office took the position that trademarks can never be like kind to tradenames. There is confusing language that might lead one to think trademarks and tradenames are good will and can never be exchanged (even within the same category). Note there is litigation pending on the general goodwill prohibition.

3. The National Office advised that under §1031(h)(2), foreign intangibles cannot be like kind to domestic intangibles. There previously had been some serious doubt about such a conclusion but unfortunately the taxpayer did not make the best possible arguments.

4. In rejecting the taxpayer's identification, the National Office said that taxpayer's identification of the assets of more than three companies violates the three property rule. The implication is that one would not count the assets within each company separately. There is no basis for such a conclusion.

CALIFORNIA FRANCHISE BOARD DEVELOPMENTS

***In the Matter of Herman A. Ahlers*¹⁶**

In this case, the California State Board of Equalization invalidated a special allocation (under §704(b)) of boot to partner who received cash from the exchange and did not want to participate in the exchange.

Identification

The California State Board of Equalization is taking the position that in order to use the 200% rule, the taxpayer must set forth valuations on the identification form.

FORM 8824

1. Instructions have been revised to eliminate the statement that a purchase of related party property through a QI will always result in application of §1031(f)(4).
2. A technical error concerning disposition within two years remains on the Form.

CAMPBELL v. BANK OF AMERICA, N.A.¹⁷

Bank of America (BoA) entered into an advisory type agreement (apparently beyond the role of just acting as a QI) with the taxpayer to accomplish a §1031 exchange. BoA put the taxpayer in contact with a TIC syndicator who agreed to give the taxpayer a put, so that after one year taxpayer could put the property back. Taxpayer exercised the put but the syndicator did not buy the property back. Taxpayer sued BoA and BoA tried (unsuccessfully) to bring the syndicator into the litigation. While the taxpayer may succeed in its litigation against BoA, Taxpayer probably should not be viewed as ever having acquired the replacement property.

OTHER CURRENT ISSUES

Ability of Taxpayer to Direct Investments in Exchange Account

In PLR 200240049, the IRS permitted the taxpayer to direct the QI to invest between two possible investments; then in Rev. Proc. 2003-39,¹⁸ the IRS stated, as a condition of qualifying the arrangement as a mass asset "LKE Program," the taxpayer must implement a process "that ensures that the intermediary controls the receipt, *holding* and disbursement of all funds to which he intermediary is entitled."¹⁹ Query whether this precludes the ability of the taxpayer to direct investments during the exchange period.

In PLR 200450005, which was the first ruling issued under Rev. Proc. 2003-39, and appears to be the same taxpayer as in PLR 200240049, the ability of the taxpayer to direct between two possible investments apparently was eliminated.

Joint Signatures on Exchange Account

A taxpayer may insist that amounts can only be disbursed from the exchange account upon the joint signature of both the QI and the taxpayer. The IRS has expressly permitted this in the mass asset exchange area.²⁰ Is there any reason why it would not apply in the non mass asset exchange area?

Footnotes

2 2006 by Howard J. Levin Howard J. Levine is a partner, in Roberts & Holland LLP, Washington, DC and New York, NY. Mr. Levine is the author of 567 T.M., *Taxfree Exchanges Under Section 1031*.

³Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

⁴2002-2 C.B. 927.

5124 T.C. No. 4 (2005).

62004-33 I.R.B. 294.

72000-2 C.B. 438.

82002-1 C.B. 733.

⁹PLR 200327003. See Levine, "First IRS Ruling on Undivided Fractional Interests Under Rev. Proc. 2002-22: IRS Takes Practical Approach in Interpreting Rev. Proc.," *Tax Mgmt. Memo.* (5/19/2003).

¹⁰See PLR 200513010. For a detailed discussion of this ruling, see Levine, "Finally, IRS Issues Ruling Under Rev. Proc. 2002-22 Involving Multi-Tenant Building With Blanket Mortgage," *Tax Mgmt. Memo.* (3/7/05).

¹¹2005-5 I.R.B. 447.

12P.L. 108-357.

¹³2005-32 I.R.B. 267.

¹⁴See Regs. §1.1002-1(c).

¹⁵2005-7 I.R.B. 528. Rev. Proc. 2005-14 is effective Jan. 27, 2005.

¹⁶Case No. 257952 (Dec. 13, 2005).

¹⁷404 F. Supp. 2d 1292 (D. Kan. 2005).

¹⁸2003-1 C.B. 971.

¹⁹Rev. Proc. 2003-39, 2003-1 C.B. 971 (emphasis added).

²⁰See Rev. Proc. 2003-39, 2003-1 C.B. 971, §5.02.

WASHINGTON ITEMS

The Climate of Current Thinking on New Developments

Note: These "Items" contain information derived from informal discussions with active tax practitioners. They reflect pertinent aspects of current Congressional, Treasury, or Internal Revenue thought or intent in various tax matters. Although Tax Management verifies this information to the extent practicable, subscribers are cautioned that any of these items is subject to change without notice.

For additional Washington tax items relating to compensation matters, please see "Washington Items," in the current issue of the Compensation Planning Journal.

The "Items" are to be regarded as unofficial, although part of the climate of current tax thinking and not infrequently harbingers of tax developments. Their nature precludes detailed editorial research. Subscribers should check applicability of a given point with their own sources before taking action on the basis of an "Item."

Comments respecting "Items" should be made in writing to: Secretary, Managing Editor, Tax Management, 1250 23rd Street, N.W., Washington, D.C. 20037.

Sellers of Stock Under Installment Method Allowed to Recover Basis Using Alternative Method

When the maximum selling price in a contingent payment installment sale cannot be determined, the seller generally must recover basis in equal amounts as payments are received. When a seller receives large contingent payments in the early years of an installment sale contract, this straight-line basis recovery rule in effect can accelerate recognition of significant percentages of the total gain, compromising the deferral benefits of installment sale reporting. In PLR 200603017, installment sellers avoided this result by obtaining the IRS's permission to recover basis using an alternative method. The ruling also speaks of the relationship between §§338(h)(10) and 453.

Two Shareholders owned the stock of the Company, an S corporation. They sold their stock to Buyer. Shareholders and the Buyer elected under §338(h)(10) to treat the sale of the stock as a deemed sale of the assets and business of the Company to Buyer followed by a liquidation of the Company. The Stock Purchase Agreement required Buyer to pay shareholders fixed payments in the year of sale and on each of the first two anniversaries of the sale date. The Agreement also required Buyer to pay Shareholders contingent payments for a prescribed number of years equal to a percentage of the amount by which the Company's annual operating income exceeded a threshold amount. The Agreement placed no maximum on the amount of the contingent payments.

The regulations under §453 characterize this type of transaction as a "contingent payment sale" for which a maximum selling price is not determinable but the time over which payments will be received is determinable. See Regs. §15A.453-1(c)(1). In general, to determine how much of each payment to recognize as gain in such sales, the seller's basis in property sold must be allocated in equal annual increments to the taxable years in which payments are received. See §453(j)(2); Regs. §15A.453-1(c)(3)(i).

Under Regs. §15A.453-1(c)(7), a taxpayer may use an alternative method of recovering basis if the taxpayer can demonstrate that application of the normal basis recovery rule will "substantially and inappropriately" defer recovery of basis. The taxpayer must show that (1) the alternative method is a reasonable method of ratably recovering basis, and (2) under the proposed method, it is reasonable to

conclude that the taxpayer likely will recover basis twice as fast as basis would have been recovered under the normal rule. A taxpayer must obtain permission to use such an alternative method by way of a favorable letter ruling. The ruling request must be filed before the due date of the return, including extensions for the taxable year in which the first installment payment is received.

In demonstrating that application of the normal basis recovery rule substantially and inappropriately would defer recovery of basis, a taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification. Ordinarily, a taxpayer may not rely on projections of future productivity, receipts, profits, or the like. In special circumstances, however, the IRS may accept a reasonable projection based upon a specific event that has occurred. See Regs. §15A.453-1(c)(7)(ii).

In considering Shareholders' ruling request for permission to use an alternative method, the IRS observed that under a §338(h)(10) election, shareholders are treated as if the cash, the issue price of qualifying installment obligations, and the fair market value of any other property received for their S corporation stock were received on a deemed sale of the S corporation's assets and then distributed by the S corporation in liquidation and received by the shareholders as the selling price of their stock. Without citing §453(h), which deals with the treatment under §453 of payments on installment obligations distributed to shareholders in certain liquidations, the IRS defined a "qualifying obligation" as one received on the sale or exchange of corporate assets by a liquidating corporation during the 12-month period beginning when the plan of liquidation is adopted. See Regs. §1.453-11. In other words, by virtue of the §338(h)(10) election, the S corporation is treated as selling its property on the installment method and then distributing the installment obligation in liquidation to its shareholders. Section 453(h) then treats the shareholders' receipt of payments on the installment obligation as installment payments for their stock. Under §453B(h), the character of their gain must be determined by reference to the deemed sale of the corporate assets. See also Regs. §1.338(h)(10)-1(d)(5)(i).

Under the method the Shareholders proposed, basis would be allocated to a particular installment payment in the same ratio that the payment bears to the aggregate anticipated payments. The estimated payments were based on the recent return earned by the Buyer's parent company on the carrying value of its investments in other businesses and on the Company's earnings history, its business, and the business cycle.

The IRS approved the use of the proposed method. The IRS concluded that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the Shareholders' basis and that using the proposed alternative method would cause them to recover basis at least twice as fast as the rate under the normal rule. Thus, the IRS concluded that the proposed alternative represented a reasonable method of basis recovery.

Taxpayers who contemplate making contingent payment installment sales should ascertain the rate at which they would recover basis under the normal rules. In appropriate circumstances, they should consider petitioning the IRS to allow an alternative method. An alternative method may be sought by ruling even when (unlike in PLR 200603017) a contingent payment installment sale states a maximum selling price. See, e.g., PLR 9638018. Note, however, that the provision for an alternative method cuts both ways. The IRS may find that the normal basis recovery rule would substantially and inappropriately *accelerate* recovery of basis. Whether or not the taxpayer has sought a ruling, the IRS may require an alternative method unless the taxpayer can demonstrate that either (1) the method the IRS

seeks to require is not a reasonable method, or (2) it is not reasonable to conclude that the taxpayer is likely to recover basis twice as fast under the normal rule as basis would be recovered under the method the IRS proposes.

For a further discussion, see Starczewski, 565 T.M., *Installment Sales*.

Conversion of Debt Instrument Results in Cancellation of Indebtedness Income

The landmark case of *U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931), resulted in the enactment of §61(a)(12), which provides that discharge of indebtedness results in gross income to the debtor. Section 108 provides certain exceptions to this rule.

One exception, the stock-for-debt exception previously found in §108, was repealed in 1993. Section 108(e)(8) (formerly §108(e)(10)) now provides that a transfer of stock by a debtor corporation to a creditor in satisfaction of its indebtedness will be treated as if the indebtedness was satisfied with an amount of money equal to the fair market value of the stock.

However, notwithstanding §108(e)(8), there are still outstanding issues in the area. For example, in PLR 200606037, taxpayer corporation (T) formed a single purpose grantor trust to issue convertible preferred securities (the "securities") which were convertible in T's common stock after a certain period of time following issuance. Payment of interest and principal on the securities was guaranteed by T.

T later petitioned for Chapter 11 bankruptcy and stopped all payment to the trust. Some holders of the securities converted their securities into T common stock at a time when the fair market value of T common stock was less than the adjusted issue price of the securities. It appears from the PLR that the conversions occurred both before and after bankruptcy was declared. T originally reported the conversion as forgiveness of indebtedness income on its federal income tax return, but later amended the return to exclude such amount from income. The IRS audited T's return.

T contended that, based on the Supreme Court's holding in *U.S. v. Centennial Savings Bank FSB*, 499 U.S. 573 (1991), no discharge of indebtedness income results when debt is converted into common stock in accordance with the terms of the original debt instrument. In *Centennial*, the Supreme Court held that prepayment penalties arising from a holder's premature redemption of a certificate of deposit did not constitute forgiveness of indebtedness income under §108 because the penalties were paid pursuant to the terms of the original contracts between the holder and the bank.

T also cited *Philip Morris, Inc. v. Comr.*, 104 T.C. 61 (1995), *aff'd*, 71 F.3d 1040 (2d Cir. 1995), *cert denied*, 517 U.S. 1220 (1996), in which both the Tax Court and Second Circuit held that no discharge of indebtedness resulted when foreign currency loans were repaid in accordance with the terms of the original loan instrument in depreciated foreign currency.

The IRS advised that *Centennial* did not apply because the court's definition of "discharge of indebtedness" did not involve a stock for debt exchange as described in §108(e)(8) -- *Centennial* dealt only with the now repealed "qualified business indebtedness" exception. The IRS stated that Congress was aware of the issue since the legislative history of §108(e)(8) provided for limited transitional

relief. T, on the other hand, argued that there was nothing in the legislative history of §108(e)(8) that made a conversion an exception to the definition of "discharge of indebtedness."

The IRS concluded, in PLR 200606037, that Congress clearly intended that a conversion right in a debt instrument constituted a discharge of indebtedness if the fair market value of the stock received is less than the adjusted issue price of the securities and stated so in the legislative history.

The reasoning of the PLR is questionable. The Supreme Court in *Centennial* did not seem to limit its holding to the "qualified business indebtedness" provision in §108 and held that there cannot be any discharge of indebtedness if the liability is paid according to the original terms of the indebtedness. The *Philip Morris* case also stands for this proposition.

For more information on this subject, see Tatlock, 540 T.M., *Discharge of Indebtedness, Bankruptcy and Insolvency*.

Gender Reassignment Surgery Expenses Do Not Qualify as Medical Expense Deduction

The Chief Counsel's Office has advised, in CCA 200603025, that "[w]ithout an unequivocal expression of Congressional intent that expenses [for male-to-female gender reassignment surgery (GRS)] qualify under section 213, allowing the medical expense deduction is not justified" Taxpayer had claimed a deduction for medical and dental expenses that included payments for various doctors, prescriptions, health insurance, transportation, and lodging in connection with the taxpayer's GRS. A revenue agent disallowed the expenses on the ground that they were for cosmetic surgery and nondeductible pursuant to §213(d)(9).

Based on documents provided by Taxpayer's representative to the Appeals Officer, including letters prepared by medical professionals who treated Taxpayer, the Chief Counsel's Office, in CCA 200603025, provided the following synopsis of the taxpayer's medical condition and treatments:

1. The taxpayer grew up with a condition known as Gender Identity Disorder (GID).

3. Beginning in Year 1, the taxpayer sought psychotherapy from a licensed social worker, Social Worker A.

4. During the course of treatment, Social Worker A formally diagnosed the taxpayer as meeting the criteria for GID.

5. In September, Year 2, subsequent to the diagnosis, the taxpayer began hormone treatment under the care of an endocrinologist.

6. In March, Year 5, the taxpayer began living as a full-time female.

7. In March, Year 5, the taxpayer legally changed his name from Taxpayer Name 2 to Taxpayer Name 1.

8. In July, Year 6, Social Worker A, in accordance with medical standards that were followed for treatment of GID, recommended the taxpayer for GRS.

9. In July, Year 6, the taxpayer met with Doctor B to be evaluated as to whether GRS was an appropriate treatment for his diagnosed GID.

10. Doctor B considered the taxpayer's GID to be profound. Several alternative treatments were considered and dismissed. Doctor B ultimately opined that the taxpayer was in need of GRS.

11. Prior to surgery, the taxpayer complied with the preparatory requirements for sex reassignment surgery. These standards are known as the Harry Benjamin Standards. See Harry Benjamin, *International Gender Dysphoria Association's Standards of Care for Gender Identity Disorders* (6th Ed.).

12. In October Year 6, the taxpayer underwent GRS.

Section 213(d)(1)(A) defines the term "medical care" as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. Section 213(d)(9)(A), however, provides that the term "medical care" does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. Section 213(d)(9)(B), in turn, defines "cosmetic surgery" as any procedure that is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or treat illness or disease.

According to the Chief Counsel's Office, the legislative history to the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, §11342, indicates that, by 1990, Congress was aware that the IRS "was interpreting the term 'medical care' to include procedures that permanently alter any structure of the body, even if the procedure generally was considered to be an elective, purely cosmetic treatment (such as removal of hair by electrolysis and face-lift operations). H.R. Rep. No. 101-964, at 1031." It was for this reason, according to the IRS, that Congress enacted the cosmetic surgery limitation in §213(d)(9), as part of the Omnibus Budget Reconciliation Act of 1990. Analyzing the Senate Report that accompanied that legislation, the IRS stated that:

As printed in the Congressional Record of October 18, 1990 at p. S 15711, the Senate Budget Committee determined that expenses for cosmetic surgery should not be eligible for the medical expense deduction absent certain circumstances clearly not present in the case of GRS (i.e., a congenital abnormality, an accident or trauma, or a disfiguring disease). The Senate Report states that expenses for purely cosmetic procedures that are not medically necessary are, in essence, voluntary personal expenditures, which like other personal expenditures (e.g., food and clothing) generally should not be deductible in computing taxable income. Id. In discussing the types of surgery which are deemed to be medically necessary, the Senate Report lists

only: (1) procedures that are medically necessary to promote the proper function of the body and which only incidentally affect the patient's appearance; and (2) procedures for treatment of a disfiguring condition arising from a congenital abnormality, personal injury, trauma, or disease (such as reconstructive surgery following the removal of a malignancy). *Id.*

Based on the foregoing, the Chief Counsel's Office concluded that Taxpayer had not satisfactorily demonstrated that the expenses incurred for Taxpayer's GRS fit within the strict boundaries set forth by Congress. According to the Chief Counsel's Office, there was nothing to substantiate that the expenses were incurred to promote the proper function of Taxpayer's body and only incidentally affect Taxpayer's appearance. The Chief Counsel's Office further reasoned that the expenses were not incurred for treatment of a disfiguring condition arising from a congenital abnormality, personal injury, trauma, or disease (such as reconstructive surgery following the removal of a malignancy). The Chief Counsel's Office added that whether gender reassignment surgery is a treatment for an illness or disease is "controversial." The Chief Counsel's Office concluded that:

[i]n light of the Congressional emphasis on denying a deduction for procedures relating to appearance in all but a few circumstances and the controversy surrounding whether GRS is a treatment for an illness or disease, the materials submitted do not support a deduction. Only an unequivocal expression of Congressional intent that expenses of this type qualify under section 213 would justify the allowance of the deduction in this case. Otherwise, it would seem we would be moving beyond the generally accepted boundaries that define this type of deduction.

Although GRS might reasonably be characterized as cosmetic surgery, the Chief Counsel's Office seemed to give short shrift to the argument that it may have been medically therapeutic. The fact that GID is not a physical deformity, and the mere assertion that its status as an illness or disease is controversial, may not fully take into account that a medical professional prescribed GRS for Taxpayer and that a significant portion of the psychiatric community considers GID a congenital abnormality.

For a further discussion, see Maule & Starczewski, 503 T.M., *Deductions: Overview and Conceptual Aspects*.

Grantor's Power to Substitute Assets of Equivalent Value Does Not Result in Inclusion of Assets in Grantor's Gross Estate

In PLR 200603040, the IRS held that a grantor's retention of the power to acquire trust property by substituting other property of equivalent value will not cause the property of the trust to be included in the grantor's gross estate under §2033, §2036(a), §2036(b), §2038 or §2039, where the trust instrument provided that the grantor's power to acquire trust property could only be exercised in a fiduciary capacity.

The value of all property owned by the decedent at the time of death is included in the decedent's gross estate under §2033. The decedent's gross estate also includes property transferred by the decedent, with respect to which he retained certain rights to control and enjoy the income or principal for life or for a period that does not end before his death. See §2036(a), (b). The value of all property transferred during the decedent's lifetime that remains subject to the decedent's right to alter, amend, revoke, or terminate the gift must be included in the decedent's gross estate under §2038. The gross estate also includes the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement if, under such contract or agreement, an annuity or other payment was payable to the decedent during life. See §2039.

Grantor created an inter vivos irrevocable trust (Trust) that was funded with cash and marketable securities. The terms of the Trust provided that the Grantor may acquire any or all property constituting Trust principal by substitution of other property of equivalent value to the property acquired. The terms of the Trust further provided that the Grantor's power to acquire Trust property could be exercised only in a fiduciary capacity, which was defined as undertaken in good faith, in the best interests of the Trust and its beneficiaries, and subject to fiduciary standards imposed under applicable state law. The Grantor desired to exercise his power of substitution. It is proposed that Grantor will transfer X shares of B stock (a publicly traded company) to Trust in exchange for Y shares of C stock (also a publicly traded company) that is currently held in Trust. In addition, to the extent necessary, Grantor will transfer to Trust, or withdraw from Trust, cash or cash equivalents in an amount necessary such that the total value of the assets Grantor is transferring to Trust will be equal to the total value of the assets Grantor is acquiring from the Trust incident to the substitution. It was represented that the value of the B stock and the C stock subject to the exchange, would be determined in accordance with Regs. §25.2512-2(b)(1).

Relying on *Jordahl Est. v. Comr.*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1, the IRS ruled that grantor's power of substitution would not cause the property of Trust to be included in the Grantor's gross estate under §2033, §2036(a), §2036(b), §2038 or §2039, noting that under the terms of the Trust, the Grantor's power to acquire Trust property could be exercised only in a fiduciary capacity. The ruling seems to imply that if the power of substitution is exercised in a nonfiduciary capacity, then the power will cause estate tax inclusion. This result indeed would be troublesome since many practitioners have relied on this power to create intentionally defective grantor trust status. Section 675(4)(C) provides that the power is "exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity." It seems, therefore, that such a power could be held by a third party. Moreover, although the power held in *Jordahl* was held as a trustee, a careful reading of the case reveals that the court implied that the rationale for excluding the property when the power was held as a fiduciary was equally applicable to powers held as an individual but the power had to be exercised in good faith and subject to fiduciary standards. The court concluded that the decedent's power to substitute property "of equal value" made the power subject to fiduciary standards. Therefore, if the IRS is relying on *Jordahl*, it should not be relevant if the trust instrument requires the power of substitution to be exercised in a fiduciary or nonfiduciary capacity as long as it is exercised in good faith and that any property substituted is of equal value to the property replaced.

For a further discussion, see Acker, 820 T.M., *Administrative Powers*.

You Are Invited to Attend the April

Tax Management Advisory Board Meeting

AGENDA:

U.S. Income

MEMORANDA:

- 1. Proposed Cost Sharing Regulations and the High Tech Industry,**
by Walter M. Kolligs, Esq.,
Ernst & Young LLP, San Francisco, CA
- 2. Trustees and the Duty to Diversify ,** *by Christopher P. Cline,*
Esq., Holland & Knight LLP,
Portland, Oregon
- 3. Economic Substance Doctrine -- Current Developments ,** *by Yoram*
Keinan, Esq., Ernst & Young LLP, Washington D.C.

TO BE HELD

TUESDAY, APRIL 25, 2006

WORLD TRADE CLUB

SAN FRANCISCO, CA

MEETING: 6:30 PM

RECEPTION: 8:00 PM

RSVP Reception follows

Requests to attend will be honored and accommodations made within the limited capacity available

and in the order in which they are received. Requests should specify the **APRIL U.S. INCOME**

MEETING and be addressed to Tax Management Inc., 1250 23rd Street, N.W., Washington, D.C. 20037-1166. For information about CPE or CLE credit hour awards, or to register, call Tangie Ricks at: 202-261-6047.