Putting Stimulus to Work On the Subprime Crisis

11 Rules for Defending Tax Shelters

A Look at the Taxpayer Advocate’s Annual Report

Is It Time to Repeal the Antichurning Rules?

Tax Policy During the Recession

Inaugurations and the Rhetoric of Revenue
Potentially we’ve got trillion dollar deficits for years to come, even with the economic recovery that we are working on at this point. I’m going to be willing to make some very difficult choices in how we get a handle on this deficit.

— President-elect Barack Obama, speaking to reporters about the nation’s long-term fiscal health. (See p. 196.)
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From the Editor:

Effective Stimulus:
Tax Credits for Homeowners

By Jennifer Brown — jbrown@tax.org

All of the talk in Washington is about stimulus and the economic crisis. Lawmakers faced with a big job want to make stimulus more effective and reduce foreclosures. What should they do? They need to begin by paying more attention to our severely weakened credit markets and financial institutions. In that vein, Martin Sullivan has an excellent suggestion: Convert the mortgage interest deduction into a credit. This is good tax policy; it channels the tax benefits of homeownership — now disproportionately available to high-income households — to the low-income households that need the most assistance. There is a lot of bang for the buck here — the proposal is effective stimulus and it would reduce foreclosures. For Sullivan’s economic analysis, turn to p. 171.

And it looks like this is just the time for Congress to look closely at Sullivan’s proposal because President-elect Obama wants a recovery plan with massive tax cuts (p. 182). Last week he began lobbying for an economic recovery plan including $300 billion in cuts for individuals and businesses. I have to point out that there is something in the Obama plan that I don’t like — the proposed “Making Work Pay” credit. It was designed to offset the regressivity of the payroll tax, providing up to $500 for individuals ($1,000 for joint filers), including those who don’t make enough to pay income tax. Why don’t I like it? It has been estimated that the credit would add approximately $20 to the average worker’s paycheck — and that isn’t going to stimulate anything.

National Taxpayer Advocate Nina Olson used her annual report to call on both Congress and the IRS to help taxpayers who are in financial trouble. Financial distress, along with simplification of the Internal Revenue Code, topped her annual list of the most serious problems facing taxpayers. She also voiced concerns about the IRS’s employment tax policies and the burgeoning number of civil penalties. As in prior years, the report offers legislative proposals, including her perennial plea for reform of the alternative minimum tax (p. 185).

Lee Sheppard has again written on my favorite topic — tax shelters. Need to defend one and the deal stinks so much you don’t know what to do? Look no further, Sheppard has some (pretty funny) advice. My favorite is: “You have to have some lipstick on your pig.” She also points out that you can’t count on privilege to keep out of evidence embarrassing things like memos with a handwritten “bs” in the margin, and you might not want to put fat cat clients in front of a jury right now. In all seriousness, however, she presents a thorough survey of recent tax shelter cases — from LILO/SILO to son-of-BOSS — analyzing who won and why. For Sheppard’s news analysis, turn to p. 176.

The new cost-sharing regs came out recently, and I printed them out the day they were released. Well, I printed part of them. I hit print, walked over to the printer, and stood there. And stood there. After killing more than one tree, I hit cancel on the printer and sat down with a huge stack of paper. I tried to read it, sighed, and then put it all in the recycle bin. My decision to read the article by Lisa Nadal on p. 191 instead was a good one.

Commentary

Alan Viard believes that fiscal stimulus must be timed almost perfectly to achieve a beneficial effect. In On the Margin, he argues that stimulus does not create output and jobs out of thin air, but rather borrows them from the future. He writes that stimulus measures should be temporary and that our expectations should be limited. Not surprisingly, he also says that government spending does not necessarily provide a larger stimulative effect than tax cuts (p. 269).

New presidents don’t like to talk about taxes in their inaugural address. Joseph Thorndike delves into this phenomenon by examining the speeches of presidents from William McKinley through George W. Bush. Thorndike isn’t surprised to find that when presidents do talk about taxes, their tone is negative. His Tax History piece appears on p. 275.

Tax returns are not subject to an absolute privilege against discovery. In a practice article, Nancy Bowen outlines strategies for defending against those discovery requests (p. 217). Bowen says that the production of federal income tax returns in nontax disputes can be avoided, or at least limited, with proper knowledge of the law. On p. 222, William Raabe, Cherie Hennig, and John Everett examine the section 168(k)(4) election in the Housing and Economic Recovery Tax Act of 2008 and

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conclude that Congress would probably like a do-over. Their article points out 10 defects in the legislation.

This week’s special report deals with the anti-churning rule in section 197(f)(9). Romina Weiss thinks the rule has outlived its usefulness and that it should be repealed in the interests of fairness and efficiency (p. 227). Zhicheng Li Swift proposes incorporating the tax expenditure concept directly into the code and using adjustment factors to improve the estimates of revenues forgone by specific tax provisions. For her analysis of tax expenditures, see p. 256. John Magee and F. Scott Farmer write that practitioners frequently pay too little attention to the procedural requirements of the 1980 Foreign Investment in Real Property Tax Act and that this results in unwanted gain recognition. They discuss how the remedial reporting rules provided by the IRS in response to requests for relief are inadequate (p. 241). Inside Tax Reform proposes cutting the payroll tax immediately by 1 percentage point to help workers suffering from rising healthcare costs, high mortgage payments, food prices, and state and local taxes. Mark J. Warshawsky thinks this is just the first step in making Social Security taxes more equitable (p. 283). In keeping with the general focus on economic distress, Robert Willens addresses the reorganization of insolvent corporations in Of Corporate Interest (p. 279).

In Memoriam

Jackie Hutchinson, a Tax Analysts employee since 2000, died on January 4. Jackie attended congressional hearings to obtain testimony and collected documents from federal agencies. She knew everyone at Tax Analysts. Her friendliness was legendary, and she never said an unkind word. To say we will miss her is an understatement.
ECONOMIC ANALYSIS

Putting Stimulus to Work on the Subprime Crisis

By Martin A. Sullivan — martysullivan@comcast.net

The current crisis calls for two main sets of policy measures. First, measures to repair the financial system. Second, measures to increase demand and restore confidence.

— International Monetary Fund report, Dec. 29, 2008

In all recessions, it makes sense for the government to boost aggregate demand with economic stimulus. This can be done directly with increases in government spending or with tax cuts that induce increased spending by consumers and businesses. Deciding exactly what to do is causing all the commotion on Capitol Hill.

To best accomplish their task, our elected representatives need to recognize that this recession is unlike all the others. Unlike every other downturn since the Great Depression, this recession was triggered by a massive meltdown of the financial system. Credit markets ceased to operate. Huge financial institutions failed or were massively subsidized by the government. For consumers and businesses, credit that was plentiful just a year ago dried up.

Perhaps it is because our lawmakers fail to see the difference between this recession and any other during their lifetime. Or perhaps it is because they are too enamored with the Keynesian prescription that insists they increase the deficit any way they want. Whatever the reason, Congress seems to be devoting disproportionate attention to stimulus and not enough to repair of the financial system.

Because Keynesian economics is not specific on what form stimulus should take, most of official Washington wants to channel stimulus into pet causes. One manifestation of this is the repeated entreaties for “twofers.” We will stimulate the economy out of recession...and rebuild infrastructure...and create a green economy...and expand healthcare...and cut taxes on business. At this shaky stage in our financial history, our economic policy should be all crisis management. Until we are well clear of the financial storm, other policy objectives — no matter how worthy — are only distractions.

The general idea of this article is to urge Congress to pay more attention to supporting our severely weakened credit markets and institutions. Before we repair the roads, we should repair the financial system. Along these lines, this article suggests a tax change that will simultaneously stimulate aggregate demand and strengthen the financial markets.

In particular, as proposed by the President’s Advisory Panel on Federal Tax Reform in 2005, Congress should consider converting the mortgage interest deduction into a credit. This would be a good tax reform anytime because it channels tax benefits of homeownership — now disproportionately available to high-income households — to low-income households who need the most assistance with meeting the costs of housing.

Before we repair the roads, we should repair the financial system.

In terms of Keynesian economics, it is a good idea because it gets money into the hands of families who are most likely to spend it. As a means of restoring health to the financial system, it is a good idea because it targets relief to low-income mortgage borrowers who pose the greatest risk to mortgage investors. The credit would reduce mortgage delinquencies and foreclosures. This in turn would reduce losses on mortgage-backed securities and increase the propensity of financial institutions to lend to businesses and consumers.

To address the needs of the financial crisis, the mortgage tax credit proposed by the tax reform panel should be modified. First, the new “foreclosure mitigation tax credit” (as we shall call it) should be refundable so it is available to all taxpayers irrespective of their income tax liability. Second, using what may be thought of as a reverse withholding mechanism, the credit should be provided directly to the mortgage servicers, who would then reduce monthly mortgage payments by the amount of the credit. Third, the credit rate should be boosted from 15 percent to 20 percent. And fourth, at least until after the recession and a reasonable transition period, mortgage borrowers...
should be given the choice between using the new credit or the current mortgage interest deduction. This feature is for the benefit of higher-bracket taxpayers who find a deduction more favorable than a tax credit. This would prevent any immediate stress at the high end of the housing market.

A foreclosure mitigation tax credit would reduce monthly mortgage payments made by low-income homeowners.

According to data from the Department of Housing and Urban Development, there were 74.7 million owner-occupied homes in the United States in 2005. Of this total, 66.1 percent — about 49.4 million — had outstanding mortgage debt. (Department of Housing and Urban Development, American Housing Survey for the United States: 2007, issued Sept. 2008.) However, data from the IRS show that only 38.6 million taxpayers used the mortgage interest deduction. (IRS historical statistics, Table 1, “Individual Income Tax Returns: Selected Income and Tax Items for Tax Years 1999-2006,” available at http://www.irs.gov.) The difference of 10.8 million is the number of mortgage borrowers who do not get a mortgage interest deduction. These are low-income individuals who are the most likely to default on their mortgage loans. These would be the primary beneficiaries of a foreclosure prevention tax credit.

As an example of how the credit would work, suppose a homeowner has $40,000 of income and a 30-year, 6.5 percent, $140,000 mortgage. Monthly mortgage payments would be a little more than $900. In the mortgage’s third year, about 82 percent of each monthly payment is interest. A tax credit equal to 20 percent of interest would reduce the monthly mortgage payment by about $180. Using middle-of-the-road assumptions about taxes and insurance, this would reduce a common metric of housing affordability, the housing cost to income ratio, from 33 percent to 28 percent. This magnitude of reduction is comparable to current government programs.

Mortgage Meltdown
Our current economic crisis was born in the housing and mortgage markets. This is a sharp contrast to the 2001 recession, when rising housing prices saved the economy from a severe downturn. And after that recession, the rise in housing prices only accelerated. During the four-year period from 2002 through 2006, average U.S. housing prices rose 60 percent. Housing prices are shown in Figure 1.
Over the same period, standards for mortgage lending rapidly deteriorated. An increasingly large share of mortgage lending was subprime. These home loans were made to borrowers who put little or no money down. Borrowers often had low income and low credit scores. Lenders often required little documentation. And an increasing number of mortgage borrowers were acquiring second homes and homes for investment. The long-term economic viability of these mortgages depended on rising housing prices.

When a wave of declining house prices swept over the mortgage market filled with subprime mortgages, disaster struck. The general collapse in housing prices began in 2006 (and prices have declined since then by 20 percent). Because second mortgages are not an option for zero or negative equity borrowers, and because mortgage loans are typically nonrecourse — meaning the only collateral at risk was the home itself — unprecedented numbers of homeowners stopped making their mortgage payments.

As shown in Figure 2, mortgage foreclosures began to rise in 2006. Foreclosure rates were particularly high for subprime mortgages. From the third quarter of 2005 through the third quarter of 2008, the foreclosure rate for subprime mortgages more than tripled — from 3.31 percent to 12.55 percent.

Goldman Sachs economist Jan Hatzius estimates total losses in a range from $473 billion, if housing prices stay at their mid-2008 levels, or to $868 billion, if housing prices decline by 20 percent from their mid-2008 levels. (“Beyond Leveraged Losses: The Balance Sheet Effects of the Home Price Down-turn,” Sept. 10, 2008, Brookings Papers on Economic Activity, Fall 2008, conference draft. In its latest budget release, the Congressional Budget Office predicts a 14 percent decline in home prices from their mid-2008 levels.) Although these are enormous numbers, they are not so large in comparison with trillion-dollar declines that occasionally occur on the stock market. Why did mortgage losses stir up so much turmoil?

Most of the troubled mortgages had been packaged into multilayered securities purchased by financial intermediaries as investments. The purchasers included commercial banks, investment banks, hedge funds, and insurance companies. These institutions play a special role in the economy. They provide financing critical to keeping the wheels of business and consumer activity in motion. When
financial intermediaries suffer losses, their capital is reduced. When their capital is reduced, they pull back on their lending. With credit availability curtailed, consumers spend less and businesses buy less capital equipment and hire fewer workers.

These large losses could not have come at a worse time for financial institutions. As the decade progressed, to increase their profits, these companies boosted their borrowing to unprecedented levels. This left them with a relatively small capital cushion given the amount of risk they were assuming.

### Preventing Foreclosures Is a Priority

Despite resistance on the part of Treasury, economists and regulators increasingly recognize that proposals targeted at preventing mortgage foreclosures should be a part of any recovery plan for the economic crisis. In a December 4 speech in Washington, Federal Reserve Chair Ben Bernanke stressed the importance of reducing foreclosures not only for families facing the loss of their homes, but for the economy as a whole:

Foreclosures create substantial social costs. Communities suffer when foreclosures are clustered, adding further downward pressure on property values. Lower property values in turn can translate to lower tax revenues for local governments, and increases in the number of vacant homes can foster vandalism and crime.

The president-elect’s transition team announced on December 7 that Sheila Bair, current chair of the FDIC, will be reappointed by Obama. Even more than Bernanke, Bair has been sounding the alarm about the need to reduce foreclosures. In a December 17 speech, Bair said she wanted to dispel the myth “that we can end the housing crisis without modifying troubled mortgages to make them affordable for millions of people facing foreclosure.” Then she added for her Washington audience:

The housing crisis was caused by loose lending practices and unaffordable mortgages. And now unnecessary foreclosures are a very serious threat to a housing recovery. Millions of Americans are saddled with mortgages they cannot afford and are in danger of losing their homes. The huge surge in foreclosures is hurting everyone by depressing housing values and putting more borrowers at risk. Many are suffering from the recession through lost jobs, lost savings, and lost communities. As regulators, we need to use our authority and clout to stop it, and get the country out of the foreclosure crisis. This has got to be the top priority.

A particularly gnawing problem in the 21st century mortgage market is how the economic interests of borrower and lender have drifted apart. This is due to securitization. In the past, when banks that originated mortgages held them on their balance sheets, the incentives of borrower and lender to avoid foreclosure were closely aligned. Now it is third-party mortgage servicers that interface with borrowers, and they have far less incentive than traditional banks to avoid foreclosure. In fact, because securitized mortgages are divided into tranches, and some tranches may actually benefit from foreclosures, servicers risk lawsuits if they accommodate borrowers with loan modifications. Also, loan modification to prevent foreclosure is a costly, labor-intensive process that can overwhelm servicers when delinquency rates are high.

### Current government programs to prevent foreclosures are not sufficient to restore health to bank balance sheets.

By acknowledging foreclosures to be part of the problem, the federal government has attempted to provide some relief. In October 2007 lenders, servicers, and counselors established a voluntary program called the Hope Now Alliance under the guidance of Treasury and HUD to modify the terms of distressed mortgages. And in 2008 Congress established the Hope for Homeowners program. This program, which began operations on October 1, allows the Federal Housing Administration to guarantee payments to lenders in exchange for a reduction in the loan principal. But there is little doubt these efforts are insufficient, as Bernanke himself has acknowledged in his December 4 speech: “The foreclosure rate remains too high, with adverse consequences for those both directly involved and for the broader economy. More needs to be done.”

A proposal floated by Bair to significantly expand these efforts is getting a lot of attention. (“Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses,” statement to the Senate Committee on Banking, Housing and Urban Affairs, Oct. 23, 2008.) Under the Bair plan, the loan modification process would be streamlined and loan guarantees (authorized by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343)) would be used as an incentive for servicers to reduce mortgage payments. The proposed reappointment of Bair, a Republican, to the FDIC by Obama is a signal that the new administration may adopt this approach.
Advantages of a Foreclosure Prevention Credit

The main advantage of the proposed foreclosure prevention tax credit is that it would make a desirable tax reform at precisely a time when it would provide substantial support to financial markets and the macroeconomy. Under current law, low-income borrowers—who are in low-tax brackets and who may not itemize—get little or no benefit from the mortgage interest deduction. Isn’t it ironic that current tax law provides the least benefit to borrowers most at risk for foreclosure?

Isn’t it ironic that current tax law provides the least benefit to borrowers most at risk for foreclosure?

At a recent House Democratic forum on the economy, Mark Zandi of Moody’s Economy.com suggested that any government stimulus should include a plan to allow homeowners facing foreclosure to reduce their mortgage burdens. “We need a large foreclosure mitigation program,” he told Democratic leaders. Zandi also called for a return to mortgage-backed securities purchases, the original primary function of the Troubled Asset Relief Program (TARP). Both of these programs, by increasing the value of mortgage securities, would free up banks’ balance sheets and allow them to resume lending.

Immediately following Zandi, Harvard economist Martin Feldstein agreed on the need for reducing foreclosures to restore banks’ capital and encourage lending. But he did not endorse TARP asset purchases because of the overwhelming complexity of pricing mortgage-backed securities.

The foreclosure mitigation tax credit being proposed here achieves the common ultimate objective of TARP purchases as well as the Bair Plan: It strengthens bank balance sheets. By restoring value to bank assets, which in turn increases bank capital, a foreclosure mitigation tax credit encourages bank lending. But the tax credit has a tremendous advantage over either of these alternatives: simplicity. Even the FDIC’s streamlined loan modification plan known as “Loan Mod in a Box” requires a determination of qualification, income verification, and extensive paperwork for the servicing company—often on a loan-by-loan basis. Most of all, it requires no approval from the holders of mortgage securities. The tax credit is a simple refundable credit. It is equal to 20 percent of any mortgage payment—period, unless the borrower opts out. The mortgage servicer receives tax credits from the government and then reduces monthly payments by the same amount.

The Credit as Part of Obama Stimulus

The foreclosure mitigation tax credit could stand alone, but it is more realistic to view it as part of the coming Obama stimulus plan.

Because the foreclosure mitigation tax credit cannot solve all the problems of the subprime crisis, it would be most effective in combination with a plan like that proposed by Bair. The tax credit and Bair proposal are complementary tools for the government’s foreclosure prevention tool kit. Availability of a foreclosure prevention tax credit would help large swaths of subprime borrowers for whom foreclosure is imminent. This would free up overworked mortgage servicers and counselors to address the borrowers with the most difficult issues and for high-income subprime borrowers who get no additional tax benefit from the credit.

To reduce the revenue cost of this proposed credit, it could be limited, as in the case of the FDIC loan modification plan, to mortgage borrowers in distress as determined by specified financial ratios. But why reduce the credit’s scope, especially at the cost of reducing simplicity when streamlining loan modification is a policy priority?

At the time of this writing, the general belief is that the Obama transition team wishes to provide middle-class tax relief consistent with proposals made during the campaign. For example, a $500 refundable tax credit is discussed as a likely possibility. It would make a lot of economic sense for a foreclosure mitigation tax credit to replace generic tax relief. It would provide superior economic stimulus because it directs proportionately more relief to low-income households. And it has the additional—and critically important—benefit of strengthening banks so they can lend.
11 Rules for Defending Tax Shelter Cases

By Lee A. Sheppard — lees@tax.org

Lee A. Sheppard is a lawyer and contributing editor to Tax Notes. This is adapted from a December 2, 2008, speech at the Minnesota Tax Institute.

Never defend your own deal.

If you don’t call in outside lawyers when deciding whether to fight, you will be calling them in later. When it will be much, much more expensive.

Planners tend to overidentify with clients. Outside litigators bring fresh eyes. They take the world as they find it. They have no parental interest in your deal, or in ignoring the bad points.


The case involved a lease-stripping deal — basically a tax shelter piled on top of another tax shelter. The partners of the hedge fund Long Term Capital Management (LTCM) were accused of having overvalued their preferred equity interest in the deal to produce huge artificial losses for themselves. The taxpayer lost at trial, and there were penalties. Then the taxpayer got new lawyers, who appealed only the penalties, which were upheld.

At trial, the lawyers who set up the deal put one of their own on the stand, with predictable results. This was the lawyer who gave the oral return filing opinion, the later written version of which the taxpayer tried to keep out of evidence as privileged. He had represented LTCM on audit and in settlement negotiations and assisted in the litigation. The judge questioned his credibility. (For discussion, see Tax Notes, Sept. 6, 2004, p. 1005, Doc 2004-17569, or 2004 TNT 173-5.)

The lawyer was put on the stand to bolster the business purpose claim. Now, the taxpayer is supposed to come to the lawyer with a business purpose when the lawyer is being asked to give an opinion, not the other way around. The court would not let the taxpayer rely on the opinion to get out of penalties, finding that the opinion did not consider the relevant facts and circumstances, and that it was based on false assumptions about profit and business purpose.

**Bad facts are any facts that contradict your form. You are trying to sustain your form.**

On appeal, the taxpayer’s new lawyers argued that the taxpayers were being punished for the misdeeds of their advisers. The appellate court was nonplused that the latter could assume profit motive and business purpose. (For coverage, see Tax Notes, Sept. 26, 2005, p. 1497, Doc 2005-19498, or 2005 TNT 184-1.)

In its terse per curiam opinion, the court noted that the trial court had found no evidence that the taxpayer received the oral opinion that it claimed to have relied on before filing its return, and that 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.

You have to have some lipstick on your pig. The judge needs a hook to find in favor of the taxpayer.
TIFD III-E Inc. v. United States (the Castle Harbour case), 459 F.3d 220 (2d Cir. 2006), Doc 2006-14691, 2006 TNT 150-8, featured a leveraged lease that was crossing over, so the taxpayer needed a new shelter in which foreign banks posed as partners for income shifting via an elaborate partnership. The banks were promised the return of their capital from a segregated stash, plus a guaranteed yield in exchange for being allocated income.

The same lawyers defended their own deal again, and won at trial showing a business purpose that passed the Second Circuit’s disjunctive economic substance test. They lost on appeal when the Second Circuit held that the banks were not partners. Neither the trial judge nor the appellate judge understood the technical partnership rules.

Litigation is about penalties. Expect to pay the tax.

The son-of-BOSS settlement offer foolishly included penalties, because the IRS was on the warpath. The IRS was operating from the view that the taxpayers owed a 40 percent valuation understatement penalty, and so a 20 percent penalty was a discount. The IRS did not count on well-heeled taxpayers being willing to wait it out. The settlement offer was unusual for its insistence on penalties and for its having preceded any litigation. (Announcement 2004-46, 2004-21 IRB 964, Doc 2004-9620, 2004 TNT 88-10.)


TETFRA partnership-level cases cannot literally consider partner-level defenses like reasonable cause because of reg. section 301.6221-1T(d). The regulation is unreasonable, but it is there and hard to get around. Stobie Creek, and Jade Trading LLC v. United States, Dkt. No. 03-261 (Ct. Fed. Cl. Dec. 21, 2007), Doc 2007-28072, 2007 TNT 149-5.

Trials are about facts. Expect to lose on the law.

You have to have some lipstick on your pig. We hope that the president-elect’s impolitic use of this useful expression does not remove it from the lexicon. To mix metaphors, you don’t want your mannequin to be naked in the shop window.

Lipstick requires being able to argue a plausible business purpose. The judge needs a hook to find in favor of the taxpayer.

ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305, Doc 98-26209, 98 TNT 162-7, aff’d, 201 F.3d 505 (D.C. Cir.), cert. denied, 121 S. Ct. 171 (2000), shows that it is risky to argue that no business purpose is necessary.

A large corporate taxpayer did one of the Merrill Lynch installment sale deals. At trial, the taxpayer took the position that it did not have to have a business purpose for the deal, that literal compliance with the rules it was abusing was enough. The taxpayer lost at trial and on appeal.

Don’t go to trial with bad facts. Settle unless you have been designated for litigation.

Bad facts are any facts that contradict your form. You are trying to sustain your form.

Unless you have a very well-planned deal, something will come along to contradict your form, and the IRS will pounce. Some retail shelter form is really sloppy. Retail customers do not get the best legal work, even though they pay a lot in fees. Cookie-cutter deals inevitably have mistakes, but even expensively lawyered deals like LILOs have inconsistencies. Some bad common facts are:

Backdated documents. In Stobie Creek, the events that created the artificial loss took place over several weeks in the spring, but lawyers were still changing the dates on documents in December to get the programmed steps in the correct order.

Bank memos. ASA Investerings featured internal bank memos that described the bank’s purported partnership equity investment as a loan.

Book treatment. In Castle Harbour, the banks booked their purported equity investments as loans.

Contrary legal documents. The only decided SILO case featured municipal documents saying that the facility had not been sold or moved from the seller’s balance sheet. AWG Leasing Trust v. United States, No. 1:07-cv-00857-JG (N.D. Ohio May 28, 2008), Doc 2008-11830, 2008 TNT 105-10.

Inconsistent acts. In the LILO case BB&T Corp. v. United States, 523 F.3d 461 (4th Cir. 2008), Doc 2008-9547, 2008 TNT 84-15, the lessor/sublessee made substantial improvements to the equipment, which it treated as its own. In AWG, the German municipal corporation had a contractual guarantee of quiet enjoyment.

Serial numbers. In a lease-stripping deal, the serial numbers of the computers on the taxpayer’s leases did not match those on the computers that the lessee was using. Andantech LLC v. Commissioner, T.C. Memo. 2002-97, Doc 2002-8572, 2002 TNT 70-10, aff’d in part and remanded in part, No. 02-1213, (D.C. Cir. June 17, 2003), Doc 2003-14649, 2003 TNT 117-8.
Impossible assumptions about future occurrences. These featured prominently in several cases. Nuclear holocaust would have been required to make ACM’s interest rate bets pay off. The German party in AWG was theoretically going to commit to overpay for a service contract and refinance the purchaser/lessors’ huge debt. The investment partnership in Stobie Creek would have made money only if the Swiss franc moved inversely to the euro.

No arm’s-length negotiation. In AWG, the SILO customers did not negotiate or even question the price of the valuable asset they were purportedly buying. Plus there was evidence that value had been jacked up to increase depreciation deductions.

Memos to the file. The family lawyer wrote “BS” in the margins of memos in the Stobie Creek son-of-BOSS case. Every piece of paper was in court.

Fees. Excessive fees are a bad fact when the court applies the opportunity cost analysis the Tax Court applied in ACM. Fees disproportionate to the expected pretax profit from the deal are routine in retail deals (Sheldon v. Commissioner, 94 T.C. 46, Dkt. No. 18208-85 (1990), Doc 90-3768, 90 TNT 114-11).

Dressing a shelter up like a business costs more, so many retail deals basically have naked mannequins in the shop window.

E-mails. All those sarcastic e-mails about what a garbage deal you have are going into evidence. Nothing is ever erased from a hard drive. Let’s talk about the Ice Cube, a little portable computer that government investigators use to copy hard drives.

What do good facts look like?

Carlos E. Sala et ux. v. United States, 552 F. Supp. 2d 1167 (D. Colo. 2008), Doc 2008-9012, 2008 TNT 80-10, featured both a taxpayer who sincerely believed he had a profit potential and a deal that was dressed up with other transactions. The case also featured a sympathetic judge and serious government misbehavior. These circumstances overcame the bad fact of the taxpayer having zeroed out his income.

It is harder for individuals to argue business purpose/profit motive. An individual needs noise in the form of other activity in the deal to distract the judge from the shelter and to dress it up like a business. Dressing a shelter up like a business costs more, so many retail deals basically have naked mannequins in the shop window.

Don’t count on privilege to keep embarrassing and detrimental things out of evidence.

Attorney-client privilege in tax matters is not as extensive as you think it is. And even if it is, it is waived at the drop of a pin. Also bear in mind that the privilege belongs to the client, not the lawyer.

A tax return is a disclosure document. Information transmitted for use on a tax return, or backup material for the information presented on the return, is not privileged.

Privilege is waived if the information is used on a tax return. In United States v. Lawless, 709 F.2d 485 (7th Cir. 1983), the Seventh Circuit held that there is no expectation of confidentiality in information transmitted for use on a tax return, regardless of whether the information was actually disclosed on the return. Implied waiver is the theory of some other circuits in their holding that tax return preparation is not privileged. United States v. Cote, 456 F.2d 142 (8th Cir. 1972).

Disclosure to accountants waives attorney-client privilege. (Cavallaro v. United States, 284 F.3d 236 (1st Cir. Apr. 1, 2002), Doc 2002-7987, 2002 TNT 65-10; Medinol, Ltd. v. Boston Scientific Corp., 214 F.R.D. 113 (S.D.N.Y. 2002).) In most situations, transaction costs would be hugely increased if lawyers had to baby-sit everything to avoid waiver. (United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).)

Opinions are not privileged. You are not entitled to have penalties waived for reliance on an opinion that no one is allowed to read. An opinion is only worth its persuasive power.

LTCM partners tried to keep a factual disconnect opinion on which the taxpayer had purportedly relied out of evidence, but were found to have waived attorney-client privilege by disclosing the gist of it to the accountant. The taxpayer did succeed in getting work product privilege for some parts of the opinion. Long Term Capital Holdings, et al. v. United States, Dkt. No. 3:01-cv-1290 (JBA) (D. Conn.), Doc 2003-1021, 2003 TNT 7-17.

KPMG tried to keep tax shelter promotional materials out of evidence in United States v. KPMG LLP, 237 F. Supp.2d 35 (D.D.C. 2002). BDO Seidman tried to withhold customer names in United States v. BDO Seidman, Regarding Promoter Examination of BDO Seidman, Appeals of John Doe and Jane Doe and Richard Roe and Mary Roe, 7th Cir., Nos. 02-3914 and 02-3915 (Dec. 18, 2002), Doc 2003-5515, 2003 TNT 41-44. Both appear to have been trying to run out the customers’ statute of limitations. This tactic only made it worse down the line. (For discussion, see Tax Notes, June 2, 2003, p. 1303, Doc 2003-13467, or 2003 TNT 106-3.)

You can get work product protection if what you’re doing is so bad that you planned in advance to protect some documents. United States v. Textron Inc. et al., No. 1:06-cv-00198 (D.R.I. Aug. 29, 2007), Doc 2007-20046, 2007 TNT 169-1. Work product cannot be asserted ex post facto. LTCM got work product for some parts of its opinion.
Regarding tax accrual workpapers, IRS officials keep saying they will only go after them in listed transactions. (Announcement 2002-63, Doc 2002-14466, 2002 TNT 117-12.) But United States v. Arthur Young & Co., 465 U.S. 816 (1984), gives them the right to get them all the time, and there is a lot of internal disagreement on this.

Textron and Regions Financial Corp. et al. v. United States, No. 2:06-cv-00895 (N.D. Ala. May 8, 2008), Doc 2008-10349, 2008 TNT 92-64, are on appeal. Both are wrongly decided. Tax accrual workpapers are not prepared for litigation. They are prepared for routine financial accounting in the ordinary course of business, which is an exception to the work product rule.

Procedure is very important.

Somebody won a case on your issue! So what? Pay very careful attention to how that result came about.

The outcome on the merits of a case can be hugely affected by procedural posture. Procedure can prevent litigants from having the argument they want to have, or it can be used to force the other party into a disadvantageous argument.

Whether there was trial on the facts is important when assessing the implications of a decision for going forward with your case, or deciding whether and how to fight a similar case.

A summary judgment on the law on your issue means your facts ain’t gonna matter. If you have the same deal, you may not be able to differentiate it to the next judge. This is what happened in the LILO cases.

In a summary judgment motion, the facts are viewed in the light most favorable to the nonmoving party. Summary judgment is proper when there is no genuine issue of material fact, and the moving party is entitled to judgment as a matter of law.

Taxpayers lost the LILO cases on motions for summary judgment. These taxpayers never expected to lose on the law. They wanted to have the arguments within the realm of leasing law and argue about the value of residual. The courts didn’t allow them to have that argument. They were stuck with their ugly facts.

BB&T, a LILO case, determined the SILO cases, because the taxpayer lost on the law.

The taxpayers lost the AWG SILO case on the facts, despite the judge accepting their version of the law. So the playing field was leasing law, not economic substance, but the taxpayer still lost. The court found no tax ownership and no pretax profit potential. The court believed that the German seller/lessee would take back the waste treatment plant using the contractual out that required no cash outlay.

The leasing bar was collectively shocked that spreadsheets didn’t carry the day in AWG. The taxpayers, a pair of regional banks, insisted that a computer program in wide use in the leveraged leasing business ensured that they had enough equity and enough profit built into their SILO deal.

Why was the LILO/SILO settlement so generous? Customers can forgo 80 percent of interest and rent deductions in exchange for having 80 percent of rental income ignored. So taxpayers could deduct 20 percent. No penalties. There would be some extra tax if taxpayers did not unwind quickly. Most took the deal. (See Doc 2008-17195 or 2008 TNT 153-1.)

The government did not ask for 100 percent of the tax because of the risk that big taxpayers would win a case. The government believed the deal had to be attractive. But the government is now demanding more penalties in son-of-BOSS retail shelter cases. Life is not fair.

Countryside Limited Partnership v. Commissioner, T.C. Memo. 2008-3, Doc 2008-61, 2008 TNT 2-15, is a crash course in trial procedure. The taxpayers got the result they wanted by controlling the issues before the court. The case was decided on a motion for summary judgment.

In Countryside, the taxpayers used a convoluted transaction that straddled tax years to have their interests in a real estate partnership redeemed for what the IRS said was a cash equivalent. The phased transaction involved multiple partnerships, the abusive failure to make a section 754 election, and the distribution of liquid privately issued notes so that rules for recognition of gain on cash distributions would not be triggered.

The taxpayer’s lawyers succeeded in moving the fight to where they wanted it to be by whacking up the case into single-issue procedures. They cleverly separated the three tax years and multiple partnerships involved, filing four cases in two different courts. The IRS did not move to consolidate, and the judge rejected IRS importuning to discuss other questions.

Basically, the IRS took the bait, and lost on a weak argument that it thought would prevail. The taxpayer won a motion on the narrow question of whether a liquid security from AIG was a cash equivalent.

Yes, that AIG — expect the taxpayer to scream about it in the next phase of the case. The IRS position on this point was aggressive and legally questionable, so it had been backed into a corner.

The taxpayer also got an undeserved economic substance holding in its favor. The court found a genuine nontax purpose in the desire of the partners to convert their real estate investment to a
different form. That is either successful tax planning or a tax-sheltered sale, depending on one’s point of view.

Litigation is expensive.

There are no discounts. You are looking at a decision whether to pay the tax and penalties or incur a potentially open-ended legal bill.

If you take the perspective that penalties are the only cost that can realistically be avoided, then the potential legal bill has to be weighed against only the cost of the penalties. If you’re heading to Tax Court, interest charges on the deficiency keep running while the lawyers’ meter is ticking.

Many of the individual taxpayers who are fighting son-of-BOSS cases are seriously rich people with boxcar deficiencies. They can afford to absorb hefty litigation costs while looking to get out of penalties. Taxpayers with smaller deficiencies basically cannot afford to fight. That fact weighed in the government’s favor when it went after tax shelters sold to salary earners in the 1980s.

Litigation chews up your business people’s time.

The only people who have fun are the litigators.

Litigation is like transfer pricing compliance in that it is a huge waste of business people’s time.

Substantiating a business purpose takes up time. Preparing business people to be witnesses takes time. Preparing business witnesses to be deposed by the government takes time.

In Castle Harbour, the taxpayer could not show a potential profit, so it put the business people on the stand with a story about how the transaction would “monetize” old commercial aircraft headed straight to Memphis, to the betterment of their personal careers. Preparing them to do this had to have been a very time-consuming project.

In AWG, the banks had the right to compel a German municipal corporation official to be a witness but did not do so, probably for fear he would contradict their story.

Coltec Industries Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (2007), showed there can be nasty surprises. Putting the business guys on the stand may have impressed the trial judge, but not the court of appeals.

There is a choice of forum.

District court is not necessarily better. Judges who are unschooled in the technical tax law may nonetheless have a healthy suspicion about goose eggs on the bottom of a tax return.

Some foreign tax credit generator cases are going to Tax Court because the banks don’t have the money to deposit the tax. Tax Court judges are technicians, who may not deserve their recent reputation as biased against taxpayers. Taxpayers could very well win one of these cases. (Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001), Doc 2002-184, 2002 TNT 1-5.)

Regarding LILo and SILO cases, going to district court did not help them. The judges thought the deals were phony. This was entirely foreseeable. Even though the government struggled with its legal arguments for a decade, a judge was going to wonder what the hell was going on when a bank was leasing some French subway cars.

Regarding son-of-BOSS cases, some district court judges empathized with rich individuals burdened by pesky taxation. Just as many thought the deals were hokey.

Litigation is a crapshoot.

You can have the best case in the world and still have a 20 percent chance of losing.

Litigation is not about the merits of the case. Not when it gets into the hands of litigators and not when it gets into the hands of a judge.

You should watch out for the kind of client who wants to go to court to be proven right all along.

You should watch out for the kind of client who wants to go to court to be proven right all along. Courts are not engaged in a metaphysical search for truth. Clients who want their actions blessed by a guy in a black robe should go to church.

The government is fighting everything to the wall. Sometimes, as in son-of-BOSS, they use a fighting regulation. Three judges addressed the validity of that fighting regulation, with two district courts holding it invalid. (Klamath Strategic Investment Fund, LLC v. United States, 440 F. Supp.2d 608 (E.D. Tex. 2006), Doc 2006-13753, 2006 TNT 140-14.)


The IRS usually issues a prospective, curative regulation or guidance to stop future cases, but it will still fight the prior deals using general principles like economic substance. There is no section 7805(b) relief for those aggressive taxpayers who got their deal done before the rules changed.

The economic substance doctrine has been rewritten in Coltec. In the Coltec formulation, if a taxpayer had no motive other than tax avoidance, the taxpayer bears a heavy burden of showing that the transaction had economic substance. Both profit potential and meaningful nontax economic effects must be shown by objective evidence.
Coltec requires that the transaction that produced the tax benefit be analyzed, meaning that extraneous features added on to dress it up should be ignored. In Stobie Creek, there was no window dressing for the judge to set aside.

"There is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate)," Federal Circuit Judge Timothy Dyk commented in Coltec.

In LILO cases, rent and interest deductions were disallowed on grounds of lack of substance, even though the deals might have passed muster under accepted leasing law. In AWG, the SILO case, the taxpayers got a favorable economic substance holding, but still lost on the question of tax ownership, which was pertinent to depreciation deductions.

Economic substance, or its kissing cousin, substance over form, has been the only option for the government in fighting old LILO cases, because so much water has passed under the bridge in the form of widely accepted tax-motivated leveraged leasing, which users of expensive equipment have come to depend on.

The IRS will assert every penalty that could conceivably apply. Judges will sometimes impose them in the alternative because they're angry at the taxpayer, as the judge did in Jade Trading.

There are judges who will refuse to apply the economic substance doctrine, but part of the crapshoot is the lack of assurance that the taxpayer will draw one of these judges. (See Countryside and Compaq, supra.)

Never ask for a jury.

We don’t have class warfare in America. There is no need for you to start a class war by inviting ordinary citizens to see how rich your client is.

Any client with enough money to hire lawyers to go to court to argue about taxes is too fat a cat for juries. In good times, the regular folks don’t mind that big shots pay no tax. In bad times, they mind very much.

Don’t forget that court is public. Your client’s financial dirty laundry is hanging out there. Willie Nelson got the record sealed in his tax shelter case because he didn’t want fans to find out how rich he was.

Even if you think your client is sympathetic, juries are unpredictable. In the LILO case Fifth Third Bancorp v. United States, No. 1:05-cv-350 (Apr. 17, 2008), Doc 2008-9425, 2008 TNT 83-17, jurors got confused by instructions that simultaneously asked them to decide leveraged lease law and economic substance. They decided that the LILO complied with leveraged lease law but had no economic substance, leaving both sides wondering who won.

If you win at trial, you could still lose on appeal. The appellate judge is not likely to retry the case. The standard of review is clear error. But he can reinterpret facts found by a trial judge. Business purpose and economic substance are legal concepts derived from facts.

The Sala decision has been appealed. The government refuses to accept a loss.


The appellate judge found no partnership existed, following a decision in the same circuit about the identical deal done by another taxpayer. Practitioners like to think they can differentiate their facts, but sometimes they are looking at a distinction without a difference.

In Castle Harbour the taxpayer convinced the trial judge that it had a business purpose for its deal, and got the judge to ignore some glaring problems with the deal that were evident from the documents. The next judge was not so willing to ignore the red flags.

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Obama Lobbies for Recovery Plan With Massive Tax Cuts

By Sam Goldfarb — sgoldfar@tax.org, Chuck O’Toole — chuck_otool@tax.org, Meg Shreve — mshreve@tax.org, Sam Young — syoung@tax.org and Wesley Elmore — welmore@tax.org

Within hours of moving to Washington, President-elect Barack Obama last week began lobbying Congress for an economic recovery plan containing some $300 billion in tax cuts for individuals and businesses.

Congressional leaders from both sides of the aisle generally approved of the direction of Obama’s plan, though they were skeptical about some of its details. They pledged to have legislation ready for a vote soon, but there was also a growing sense that the bill would likely proceed through the standard committee process.

Obama’s proposal includes initiatives from his presidential campaign that are supposed to help workers and create jobs, as well as other proposals that some lawmakers have championed as providing needed assistance to businesses.

One campaign proposal — the “Making Work Pay” credit — would account for roughly half the cost of the entire tax package. Designed to offset the regressivity of the payroll tax, it would provide up to $500 to individuals ($1,000 to joint filers), including those who don’t earn enough to pay income tax.

During the campaign, the Obama team said that the credit would be available to workers who make under $200,000. In a speech last week, Obama reinforced that notion, saying that “95 percent of working families” would receive a tax break under his stimulus plan. Based on the total cost of the PARTIES FINALIZE SEATS ON WAYS AND MEANS

House Republicans last week picked six new taxwriters to fill their depleted ranks on the Ways and Means Committee and fill all of the remaining empty seats on the committee. House Democrats filled their remaining slot on the committee earlier in the week.

Ways and Means ranking minority member Dave Camp, R-Mich., announced in a release that Reps. Charles W. Boustany Jr. of Louisiana, Ginny Brown-Waite of Florida, Geoff Davis of Kentucky, Dean Heller of Nevada, David G. Reichert of Washington, and Peter J. Roskam of Illinois will join his party’s caucus. Camp praised the new members for their “wealth of experience, knowledge and enthusiasm.” (For the release, see Doc 2009-319 or 2009 TNT 4-33.)

Boustany and Brown-Waite both bring backgrounds in health policy to the committee — Boustany as a former cardiovascular surgeon and Brown-Waite as a former state legislator who focused much of her attention on the health industry. Brown-Waite introduced legislation in 2007 to provide an above-the-line deduction for long-term care costs. (For H.R. 2482, see Doc 2007-21372 or 2007 TNT 183-22.)

Davis serves as a deputy whip in the House GOP leadership and has advocated using tax subsidies to support clean coal production. Reichert, who represents the Seattle suburbs, was one of 2008’s least loyal Republicans in terms of voting habits, voting with his party only 75 percent of the time and with President Bush just 53 percent of the time, according to Congressional Quarterly. His record on tax policy is similarly mixed, supporting both Democratic bills promoting alternative energy tax subsidies but also backing permanent extension of the 2001 and 2003 tax cuts.

Roskam and Heller, both in their second congressional term, served on the House Financial Services Committee as freshmen and have also advocated making the 2001 and 2003 tax cuts permanent.

Ways and Means Republicans lost eight of their members at the end of 2008 to retirement or electoral defeat, including then-ranking minority member Jim McCrery of Louisiana. Two of those seats shifted to Democratic control when the committee reallocated membership to reflect Democratic gains in the full House. The committee ratio now stands at 26 Democrats to 15 Republicans.

Democrats filled their last open seat earlier in the week, when Rep. Linda T. Sánchez, D-Calif., was named to the committee. Sister to Rep. Loretta Sanchez, D-Calif., Linda Sánchez joined the House in 2002 and chaired the Commercial and Administrative Law Subcommittee of the House Judiciary Committee in the 110th Congress. She is known for her strongly liberal voting record, and has a 98 percent lifetime “right” rating from the AFL-CIO.

Linda Sánchez fills the Ways and Means seat left open when Rep. Raúl M. Grijalva, D-Ariz., unexpectedly declined appointment to the committee in December. Grijalva opted to maintain his subcommittee chairmanship on the House Natural Resources Committee. (For prior coverage, see Tax Notes, Dec. 22, 2008, p. 1358, Doc 2008-26444, or 2008 TNT 243-1.)

— Chuck O’Toole
proposal, the nonpartisan Tax Policy Center previously estimated that the credit would begin to phase out for those making over $75,000.

Obama said that ‘95 percent of working families’ would receive a tax break under his stimulus plan.

The other proposal held over from the campaign is a one-year credit to businesses that make new hires or avoid layoffs. While Obama transition aides have only said that the overall cost of the proposal could be $40 billion to $50 billion, the estimate during the campaign was that the credit could provide businesses with as much as $3,000 for each new hire. (For prior coverage, see Tax Notes, Oct. 20, 2008, p. 239, Doc 2008-21909, or 2008 TNT 200-1.)

Additional business tax cuts under consideration include a two-year extension of current 50 percent bonus depreciation and a five-year net operating loss carryback provision for losses in 2008 and 2009. Under present law, businesses can apply losses to only two prior years. (For prior coverage, see Tax Notes, Dec. 15, 2008, p. 1233, Doc 2008-26141, or 2008 TNT 240-5.)

Obama’s plan would also raise expensing limits for small businesses from $175,000 to $250,000 in 2009 and 2010.

A spokesperson for the Obama transition team confirmed the details of the tax cut proposals, which were first reported by major national newspapers the day before the newly convening 111th Congress was sworn in.

Lawmakers Critical

Near the end of a busy first week, Senate Finance Committee Chair Max Baucus, D-Mont., predicted that “when all is said and done, we will pass legislation that is fairly close” to the Obama plan.

Yet many Democrats have strong reservations about the plan.

Democrats on the Finance Committee told reporters that Obama’s centerpiece tax proposals — a $3,000-per-new-hire tax credit for companies that create new jobs and a $500 credit for individual workers ($1,000 for joint filers) — seem difficult to put into practice and unlikely to succeed.

Finance Committee member John F. Kerry, D-Mass., said the job creation credit would not spur hiring by businesses hampered by a lack of demand. “The creation of a tax credit [to] enable them to hire is not going to make up for the lack of goods being sold or the change of confidence in the economy,” Kerry said. “You have to do the things that come first.”

Senate taxwriter and Budget Committee Chair Kent Conrad, D-N.D., echoed Kerry, saying, “If I am an auto manufacturer, why am I going to hire more people when the cars aren’t selling?”

Conrad also criticized the $500 credit for individuals. According to transition aides, that credit, equal to 6.2 percent of the first $8,100 in income earned by workers, could be implemented by reducing the amount of payroll or income tax withheld from paychecks for a limited period.

Conrad estimated that that would add $20 to the average worker’s paycheck. “I don’t see how that will do much to encourage spending,” he said.

Kerry, Conrad, and fellow taxwriter Ron Wyden, D-Ore., said they would prefer to see more of the package devoted to infrastructure improvements that would enhance the country’s economic competitiveness.

The senators made the comments following a closed-door, bipartisan committee meeting.

Despite all the criticism, participants described the meeting as “positive,” and Republicans in the meeting were cautiously optimistic. Finance Committee ranking minority member Chuck Grassley, R-Iowa, said he would like to see more tax benefits for businesses to spur private investment, but said he was pleased with the bipartisan spirit of discussions.

Timing Discussed

Baucus, meanwhile, said he was “very tentatively” planning to mark up a stimulus bill January 22.

The potential timing of legislation was also discussed on the other side of the Capitol. House Majority Leader Steny H. Hoyer, D-Md., told reporters last week that he expected a House package to come together soon — possibly within the month.

“I think we were somewhat unrealistic, given the complexity, that we could pass this in these two weeks,” Hoyer said. “We need to make sure that we have the money distributed in a way that will effect the end we want.”

House Speaker Nancy Pelosi, D-Calif., emphasized that legislation should not lag for several weeks after the initial Inauguration Day goal.

“We must pass an economic recovery and jobs package no later than mid-February, in my view,” Pelosi said last week at a House Democratic Steering and Policy Committee hearing on economic stimulus plans.

At the same time, high-ranking Democratic taxwriters were calling for hearings on the legislation.

House Ways and Means Committee members Richard E. Neal, D-Mass., and Jim McDermott,
D-Wash., both said they would push for committee hearings when Democratic committee members met later in the week.

“I have never come across one piece of legislation yet that wasn’t improved by going through the regular order,” said Neal, who chairs the Ways and Means Select Revenue Measures Subcommittee. “We’re talking about $300 billion in tax cuts. . . . You need to have a conversation about things like that, and the best way to do it is through the committee structure.”


“I want people to come in and educate the committee,” McDermott said.

Both taxwriters said they had not yet spoken with Ways and Means Chair Charles B. Rangel, D-N.Y., about the possibility of hearings or other details of the proposed package. A Rangel aide declined to comment.

Rangel Calls for Corporate Rate Cut

Rangel appeared at the Steering and Policy Committee hearing, where he talked about longer-term tax issues along with the recovery package.

Rangel called for a reduction in the corporate tax rate, stressing it “has been long overdue.”

‘The creation of a tax credit to enable them to hire is not going to make up for the lack of goods being sold or the change of confidence in the economy,’ said Kerry.

Rangel said that although lowering the corporate tax rate would not be difficult to accomplish, “the problem politically is that we need some help in removing the loopholes that are there that are enjoyed by certain businesses and certain people that have really gamed the tax system.”

Rangel suggested that during the current economic downturn, businesses should acknowledge that sacrifices need to be made and work with Congress to close those loopholes.

Other witnesses suggested several tax incentives that could help spur an economic recovery. Economist and Harvard professor Martin Feldstein, who testified in favor of the inclusion of a corporate rate cut in stimulus legislation, cautioned that any legislation to reform corporate taxation should be shaped in a way that makes it “more attractive for American firms to locate in the United States rather than to put those businesses abroad.” Some of the provisions Rangel referred to as loopholes might in fact be “explicit incentives to invest in the United States,” Feldstein added.

“I think it’s a question of cutting out those things which don’t help to attract businesses to the U.S. while shaping the entire package to make it more attractive for businesses to invest here and to create jobs here,” Feldstein said.

Rangel included a corporate rate reduction of 4.5 percentage points in his “mother of all tax reforms” bill (H.R. 3970), introduced in 2007. (For the bill, see Doc 2007-23857 or 2007 TNT 208-20.) Many Republican lawmakers and other critics, however, were dissatisfied with other provisions in the bill and called for a steeper cut in the corporate rate.

Tax Incentives

Although much of the House hearing focused on proposals to increase spending and fund infrastructure projects under the stimulus legislation, witnesses agreed that tax incentives that spur consumer spending should also be part of any package.

In addition to lowering the corporate rate, Feldstein in his testimony recommended longer-term tax policies. Were Obama to announce that he would prolong the Bush tax cuts on higher-income taxpayers for five years or more while also leaving the reduced rates on capital gains and dividends unchanged, Feldstein said, those promises would lead to increased aggregate spending and increased business investment now. Mark Zandi of Moody’s Economy.com echoed that recommendation in his own testimony.

Other tax incentives recommended by Feldstein included an increase in the research credit and enactment of Obama’s promised permanent tax cut of $500 per employed person. That act alone “would generate an annual tax cut of about $70 billion and would probably raise annual consumer spending by about $50 billion,” he said.

Both Zandi and former Clinton administration official Robert Reich, who served as labor secretary, also called for enactment of the Obama tax cut.

Reich’s other recommendations were aimed at lower-income individuals who he said would be more likely to spend any tax benefits, thus giving the economy a bigger boost than policies aimed at higher-income individuals. His recommendations included making the child tax credit fully refundable, expanding the earned income tax credit, and providing a temporary holiday from sales taxes and from payroll taxes on the first $15,000 of wages.

Witnesses also agreed, however, that spending and tax policy alone would not be enough to combat the current recession. They noted that unless action is taken to fix the credit markets and mitigate home foreclosures, unemployment will
continue to rise and there will be no chance for sustained long-term economic growth.

Feldstein and Zandi both said that the remaining $350 billion made available to the Troubled Asset Relief Program under the financial bailout bill (P.L. 110-343) should be used to help homeowners with distressed mortgages.

**Speed and Size**

Witnesses were also adamant that the package be passed sooner rather than later if it is to have its intended effect.

“The only way out is through aggressive and quick government action,” said Zandi.

The danger “is not that the government will do too much. The danger is that the government will be doing too little,” said Reich, adding that the cost of the package should be $900 billion or greater over two years. If the package is less than that amount, 3 million additional jobs will be lost, and the unemployment rate will be 10 percent in 2010, he said.

**Democratic Agenda**

The challenge posed by the stimulus package didn’t stop Senate Democratic leaders from announcing a to-do list for 2009 that includes education, healthcare, and tax incentives aimed at middle-income earners, along with economic recovery.

Finance Committee member Charles E. Schumer, D-N.Y., promised to “focus like a laser on middle-class families and what they need.” He said Democrats would double the child tax credit, expand the dependent care credit, increase the tuition deduction to $3,000 per student and $9,000 per family, and establish a tax credit for families caring for aging parents not living with them.

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**Taxpayer Advocate Recommends Help for Distressed Taxpayers**

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With a new administration disembarking at a time of economic turmoil, National Taxpayer Advocate Nina Olson used her annual report to Congress to call on the IRS and lawmakers to help taxpayers who are in financial trouble and to simplify the code through major reforms.

Those topics topped Olson’s annual list of the 20 most serious problems facing taxpayers; they are the anchor of her report, which was released and delivered to Congress last week. (For Olson’s executive summary and report, see Doc 2009-241 or 2009 TNT 4-21. For a related IRS release, see Doc 2009-240 or 2009 TNT 4-10.)

Olson also voiced concern that the IRS’s employment tax policies may overreach and turn back important taxpayer protections. She said the burgeoning number of civil penalties in the tax code includes many that are obscure or unduly harsh, citing the example of section 6707A’s minimum penalty for involvement in a tax shelter. And her report makes recommendations for reaching out to struggling tax-exempt organizations, as well as for simplifying and consolidating various higher education and retirement tax benefits. (For related coverage, see p. 202.)

As in previous reports, Olson offered legislative proposals — including a perennial plea for reform of the alternative minimum tax, which affects an increasing proportion of taxpayers — and looked at the most litigated tax issues. She weighed in on the ongoing debate over whether to regulate paid preparers, a move she favors.

‘Taxpayers who previously were able to pay their taxes find themselves unemployed, behind on housing payments, and unable to meet their basic living expenses,’ Olson wrote.

Olson praised tax administrators for successfully delivering economic stimulus rebates to about 119 million Americans in 2008 and for executing several late-year tax law changes. But she said that the prospect of a deepening economic recession in 2009 requires the IRS to consider the circumstances of taxpayers facing financial hardship before it initiates enforcement actions.
“Taxpayers who previously were able to pay their taxes find themselves unemployed, behind on housing payments, and unable to meet their basic living expenses,” Olson wrote.

Olson’s recommendations for easing the burden on taxpayers in financial hardship began with the IRS using more alternative methods to collect delinquent tax debts, such as offers in compromise and installment agreements, which she said may be more effective than increasing the application of liens and levies.

Culling historical enforcement data, she showed that the number of levies issued by the IRS increased by 1,608 percent from fiscal 2000 to fiscal 2007, from 220,000 levies to more than 3.75 million. But the increase in the total collection yield during the period was less than 45 percent.

Olson said that the IRS should reserve the more intrusive tools of liens and levies for situations involving the most uncooperative taxpayers. “The line between ‘won’t pay’ and ‘can’t pay’ is a fine one, especially in today’s tough economic times when taxpayers feel desperate,” Olson wrote.

Olson also recommended that the IRS develop a uniform policy statement defining economic hardship, provide guidance in the Internal Revenue Manual that requires the IRS to consider the economic situation of a taxpayer before any decisions are made, and establish a screening system to exclude low-income Social Security recipients with tax debts from continuous, automated tax withholding under the Federal Payment Levy Program.

PRACTITIONERS DEBATE DEFINITION OF NONRECURSE AND RECOURSE DEBT

Because section 1001 lacks a definition of recourse or nonrecourse debt, that classification can be based on state law, practitioners generally agreed at a District of Columbia Bar luncheon last week on partnership liabilities. But many at the session, which was sponsored by the Passthroughs and Real Estate Committee of the Taxation Section, struggled with the implications of a 2006 case seemingly inconsistent with such an analysis.

Under state law, when a partnership takes out a loan and the loan documents limit lender recovery to specific assets, the debt is generally considered to be nonrecourse, meaning that the lender can only pursue those specific assets to satisfy the debt, limiting the partners’ general liability. Practitioners rely on that definition to determine the characterization of debt under section 1001.

“That was the thinking that we had all signed onto until we read this case,” said Blake Rubin of McDermott Will & Emery, referring to Great Plains Gasification Associates et al. v. Commissioner, T.C. Memo. 2006-276, No. 10578-01 (Dec. 27, 2006), Doc 2006-25732, 2006 TNT 249-4.

In Great Plains Gasification, Rubin said, the court “seemed to agree that because it was nonrecourse from a [section] 752 perspective, that it was also nonrecourse from a [section] 1001 perspective,” which would in effect shift the agreed definition of nonrecourse and recourse debt for purposes of section 1001 from one that focuses on the loan documents (under state law) to an analysis of whether a partner bears the economic risk of loss for that liability (under section 752).

A government panelist declined to take a firm position on the matter but did speak to the precedential weight of the opinion. “All the parties seem to agree in the litigation that it was nonrecourse debt, and I don’t really think that the court made an independent determination that it was nonrecourse or recourse. It kind of just glossed over that,” said Beverly Katz, special counsel to the associate chief counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries). “So I’m not sure how much we can rely on this case for any principles on that.”

“I think you can appropriately conclude, notwithstanding this case, that there’s at least substantial authority for a contrary position,” Rubin said. If you look at the definition in section 704(b) of partner nonrecourse liability (which is nonrecourse for section 1001 but recourse for section 752), “that clearly compels the conclusion to me that it can’t be the case that the [section] 1001 determination is the same as the [section] 752 determination, because if so you’d have a null set for partner nonrecourse debt.”

— Amy S. Elliott
Untangling the Complexity

The national taxpayer advocate named code complexity as the top problem confronting taxpayers in 2008, citing specific issues in which complexity created unnecessary confusion and burdens on taxpayers. She recommended ways Congress could remedy those issues.

To illustrate the problems created by undue complexity, a Taxpayer Advocate Service study calculated that individual and business taxpayers spent 7.6 billion hours and $193 billion per year to comply with basic filing requirements. To keep up with the hundreds of tax law changes added each year, 80 percent of taxpayers pay for assistance from either a tax professional or preparation software.

Even then, Olson said in the report, the complexity of the code leads many honest taxpayers to either underpay their taxes or underpay and face enforcement action, while more knowledgeable taxpayers may exploit loopholes to reduce their tax liabilities.

For example, the earned income tax credit is so complex that nearly 73 percent of low-income taxpayers who claim the credit use a tax professional to file their return, a move the report says was counter to the expectation that individuals with lower incomes are more likely to require simpler returns. Also, the code is constantly changed and augmented. Since 2001, the report says, more than 3,250 tax code changes have been implemented, including more than 500 in 2008. Also, errors have become more costly. More than 130 civil penalties are now laid out in the tax code, nearly a tenfold increase from 1954.

Legislative Recommendations

Strategies to streamline tax code complexity were plentiful in the report’s list of legislative recommendations. The first recommendation is to repeal the AMT for individual taxpayers. The AMT requires taxpayers to calculate two sets of tax returns, one governed by regular income tax rules and one by AMT rules, and then pay the higher of the two tax totals. The AMT also disallows some tax deductions, notably those for dependents and for state and local tax payments. Another major issue is that the AMT is not indexed for inflation. (For prior coverage, see Tax Notes, Oct. 6, 2008, p. 9, Doc 2008-21185, or 2008 TNT 194-2.)

“When Congress first enacted a minimum tax in 1969, the exemption amount was $30,000 for all taxpayers,” Olson said in the report. “If that amount had been indexed, it would be equal to about $177,000 today.” As a result, 33 million individual taxpayers, or 35 percent of individual filers who pay income tax, will be subject to the AMT in 2010, according to the report. Olson recommended that Congress enact fundamental tax reform that includes a repeal of the AMT.

Another recommendation is that Congress simplify procedures for cancellation of debt. Although canceled debt is considered taxable income in most scenarios, taxpayers who lose their homes to foreclosure may apply to have the cancellation of their mortgage debt excluded from their total taxable income. To apply, Olson noted, taxpayers must complete Form 982, a complex document not included in many tax return preparation software packages.

The form takes more than 10 hours to complete, according to the IRS, and the national taxpayer advocate’s report says that many return preparers may not be familiar with it. Hence, many taxpayers who qualify do not take advantage of the exclusion, and those who try to exclude their debt without Form 982 may face IRS examination, the report says. Congress should set a minimum debt threshold and exclude taxpayers with debt below that minimum from the rules on cancellation of debt income, the report recommends. Also, Olson said the IRS should create a centralized unit to handle cancellation of debt issues and develop an insolvency worksheet that taxpayers can submit with their returns.

Equally in need of reform are the code’s temporary provisions, Olson wrote. To ameliorate budget shortfalls, Congress often enacts tax measures that expire after a specified amount of time, or incentives that phase out if a taxpayer earns more than a specified amount. The code now contains more than 100 provisions with an expiration date, a more than fourfold increase from 1992. Provisions with sunset dates and phaseout income thresholds create uncertainty and make it more difficult for taxpayers to estimate liabilities and pay sufficient estimated taxes. Also, those incentives complicate return processing for the IRS and ultimately reduce the effectiveness of those tax incentives.

What’s more, the report says, phaseouts foster inequality through the creation of “marginal ‘rate bubbles’” — income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer.”
The national taxpayer advocate recommended eliminating, or at least simplifying, phaseout and sunset provisions and removing the legislative incentives to use temporary provisions in the future.

Revisiting another legislative proposal from a previous report, Olson emphasized that “the time has come to regulate tax return preparers.” Those include unregulated “unenrolled” preparers, as well as regulated attorneys, CPAs, and enrolled agents.

**Congress should enact a registration, examination, certification, and enforcement program for unenrolled preparers, Olson recommended.**

With more than 60 percent of individual taxpayers and most business taxpayers paying practitioners to prepare and file their returns, Congress should enact a registration, examination, certification, and enforcement program for unenrolled preparers, Olson recommended. H.R. 5716, the Taxpayer’s Bill of Rights Act of 2008, was referred to the House Ways and Means Committee last April and is modeled after Olson’s initial recommendation in her 2002 annual report. (For the text of H.R. 5716, see Doc 2008-8548 or 2008 TNT 75-37. For prior coverage, see Tax Notes, Sept. 15, 2008, p. 1020, Doc 2008-19425, or 2008 TNT 178-5.)

**Penalty Reform**

Another highlight of the report is the recommendation that Congress undertake serious penalty reform. The number of civil tax penalties has ballooned from 14 in 1954 to more than 130 today, the report notes. Given that the last time Congress seriously addressed the penalty regime was after a comprehensive study in 1989, Olson called for a multipronged approach to tackle the penalty labyrinth that has since evolved.

For the longer term, the report asks Congress to require the IRS to regularly collect detailed penalty data and study the effect of each penalty on voluntary compliance. For the immediate future, Olson advocated making 11 common-sense reforms based on work done by the Joint Committee on Taxation and the IRS in preparation for the 1989 reforms. An ideal penalty regime, the report says, should be based on the principles of fairness, comprehensibility, effectiveness, and ease of administration.

Using tax gap and litigation data, the report suggests that Congress focus on penalties for underreporting, failure to pay, and failure to file, given their frequent application. Olson also said that the high level of penalty occurrence in those areas might be a sign the penalties are either not understood by taxpayers or are applied too often by the IRS without adequate support. And the report strongly urges the IRS to clarify the definition of tax shelter for purposes of the substantial understatement penalty so as to minimize the risk of taxpayers being covered under the current broad definition merely by claiming tax benefits Congress intended them to have.

Olson singled out the penalty under section 6707A for failure to make disclosure of reportable transactions the poster child for out-of-line tax penalties in need of modification. That penalty is “unconscionable and possibly unconstitutional,” the report says. The penalty can be imposed on taxpayers who fail to make the appropriate disclosure, even when the taxpayer had no knowledge the transaction was reportable, there were no material tax savings involved, or the transaction was listed and made retroactive to tax years for which the taxpayer had filed a return — all factors evidencing the lack of taxpayer culpability, the report says.

**The section 6707A penalty for failure to disclose a reportable transaction is ‘unconscionable and possibly unconstitutional,’ according to the report.**

Many practitioners agreed. “Overapplication of harsh penalties based in a complex, almost incomprehensible tax code should not serve as the foundation for our system of taxation and the administration of the tax laws within the United States,” Charles Rettig of Hochman, Salkin, Rettig, Toscher & Perez told Tax Analysts. “Fairness and restraint should serve as the foundation for penalty considerations by Congress, which has the ability to fix the penalty regime prospectively rather than force the federal courts to deal with it on a case-by-case basis with differing results around the country.”

Because the strict liability of section 6707A imposes a penalty of $100,000 on any individual, or $200,000 on any entity, for failure to make a required disclosure of a listed transaction — or $10,000 for individuals and $50,000 for entities if the transaction is not listed but reportable — it “may have the effect of bankrupting middle-class families who had no intention of entering into a tax shelter,” the report says. Other problems mentioned include the penalty’s requirement that only the IRS commissioner may rescind an assessed penalty, and the lack of judicial review of a rescission decision.
As a result, the penalty provision “raises significant constitutional concerns, including possible violation of the Eighth Amendment,” the report says. To bolster its case for lessening the potential harsh impact of the penalty, the report quotes an Appeals officer who said, “In my 29 years with the IRS I have never [before] worked a case or issue that left me questioning whether in good conscience I could uphold the government’s position even though it is supported by the language of the law.”

Some practitioners have argued that practical relief can be achieved through the ways in which the IRS administers the penalty, such as not making the listing notices retroactive. But Olson recommended that Congress take on the task of fixing the section to ensure a proportional relationship between the penalty amount and the taxpayer’s tax savings realized from the transaction, including the ability of the IRS to waive the penalty. The report notes that the Taxpayer Advocate Service had roughly 40 cases in its inventory involving the section 6707A penalty, and estimates that the IRS could impose the penalty in hundreds of others.

Walter Goldberg, executive director of the national tax office of Grant Thornton LLP, agreed with Olson’s call for modifying the section 6707A penalty. “It is an unusual penalty in that it doesn’t provide any possibility for relief for the failure to disclose listed transactions, and utilizes a rescission procedure rather than looking to see if the taxpayer had reasonable cause for the failure to disclose nonlisted reportable transactions,” he told Tax Analysts. “It is right for Congress to take another look to ensure that section 6707A operates consistently with the stated goal behind civil tax penalties of enhancing voluntary compliance,” he said.

Ian Comiskey of Blank Rome LLP told Tax Analysts, “It’s a terribly unfair penalty in many circumstances, and Congress could not have anticipated the situations in which the penalty applied, entrapping innocent taxpayers who had no intention of engaging in tax shelters.”

**Leniency on Employer Tax Compliance**

Small businesses may find things to their liking in the 2008 report. That was not the case in 2007, when many small employers complained about Olson’s aggressive proposals to reduce underreported income from the cash economy — including various recommendations to increase information reporting and voluntary withholding.

“The rate of compliance among employment taxpayers is quite high,” Olson wrote in 2008. “The IRS needs to take a balanced approach” to its collection of unpaid payroll taxes and reconsider policies that may “overreach and undermine” taxpayer protections.

Olson criticized a Government Accountability Office study released in July that found that employment tax noncompliance had increased over the last 10 years. The report, which Olson questioned as possibly misleading, prompted Sen. Carl Levin, D-Mich., and other members of Congress at a July Senate hearing to call for the IRS to mobilize its resources in an aggressive effort to collect outstanding payroll tax debt.

‘The rate of compliance among employment taxpayers is quite high,’ Olson wrote in the report.

Olson’s report says that the GAO did not adjust its figures for inflation and that, once making that adjustment, the employment tax gap actually shrank over the past decade. (For prior coverage, see Tax Notes, Aug. 4, 2008, p. 413, Doc 2008-16673, or 2008 TNT 147-1. For the report (GAO-08-617), see Doc 2008-16622 or 2008 TNT 147-26.)

Focusing on the relatively high rate of employment tax compliance, Olson took a more sympathetic, softer approach in her recommendations. She urged the Service to target its response to the taxpayer’s individual reason for noncompliance (whether it stems from intention, confusion, or cash flow problems) and act quickly at the first sign of a delinquency to prevent the accumulation of substantial unpaid payroll taxes.

Olson did not let up, however, on her efforts to address what she characterizes as “the growing worker misclassification problem.” Whether an employer classifies its workers as employees (subject to withholding) or independent contractors is based on a test that looks at the facts surrounding the employment relationship. Olson pointed out that the determination is “complicated and confusing, in part because the rules are not the same” for federal income taxes as they are for state employment taxes.

One of Olson’s legislative recommendations in this arena is to repeal the safe harbor in section 530 of the Revenue Act of 1978, which effectively allows employers to sidestep the “complicated” test and treat workers as independent contractors if, for instance, it is considered industry practice. That move has gained momentum in Congress, with President-elect Barack Obama calling for the repeal of section 530 in S. 2044 as a way to reduce confusion and “close its use as a tax loophole.”

But critics say repeal of section 530 could bring the fall of whole industries that have been built on the certainty of this safe harbor. “While the objective of harmonizing a worker’s status for purposes of both employment taxes and income taxes is
laudable,” Russell A. Hollrah told Tax Analysts, “its pursuit would be advisable only if there were some assurance that the new safe harbor provision would continue to cover the relationships that section 530 currently covers.” Hollrah is the executive director of the Coalition to Preserve Independent Contractor Status, an organization that was cited in the report as encouraging enhanced Form 1099 information reporting requirements for independent contractors.

**While taxpayers generally fare better when represented, pro se taxpayers had a higher success rate in gross income and civil damage cases than did represented taxpayers.**

Otherwise, “companies would be less willing to take the risk of contracting with independent contractors” and Congress would risk the return of an “institutional bias against independent contractors,” Hollrah added. “In today’s economy, many talented individuals have lost their jobs due to external factors and are seeking to work as independent contractors. Thus, now is an especially inappropriate time to eliminate that certainty.”

**The Most Litigated Issues**

The report’s list of the 10 most litigated tax issues presents the same issues that were listed in 2007. Continuing to receive the most litigation were cases involving the following: collection due process appeals, gross income, summons enforcement, civil damages for unauthorized collection actions, frivolous issue penalties, failure-to-file penalties, trade or business expenses, accuracy-related penalties, innocent spouse relief, and family status. (For the 2007 report, see Doc 2007-671 or 2007 TNT 7-33. For coverage of the 2007 report, see Tax Notes, Jan. 14, 2008, p. 239, Doc 2008-484, or 2008 TNT 7-1.)

But the ranking of the issues did change for 2008. Gross income moved to first place, largely as a result of a significant number of cases filed questioning whether income earned in Antarctica was excluded from gross income. Trade and business expenses jumped to fourth place, with 116 reported cases in 2008, up from 77 in 2007. Summons enforcement cases also saw an increase, from 112 in 2007 to 146 in 2008. Olson predicted even more of those cases in the future as the IRS continues its aggressive summons enforcement policy. Taxpayers, however, face an uphill battle in the courts; only three cases were decided in a taxpayer’s favor in 2008.

The case categories involving the highest rate of pro se litigation were family status issues (97 percent), frivolous issues penalties (92 percent), and civil damages for some unauthorized collections (77 percent). The report notes that while taxpayers generally fare better when represented, pro se taxpayers had a higher success rate in gross income and civil damage cases than did represented taxpayers. The most likely attributable link is communication failure at the administrative level between taxpayers and the IRS, the report says.

In making recommendations based on analysis of the highlighted litigation categories, the report suggests that the IRS incorporate the rationale of court decisions that went against the government in accuracy-related penalty cases into employee training and IRM provisions. After noting several district court decisions that precluded taxpayers from asserting innocent spouse relief as an affirmative defense in district court proceedings, the report also advises Congress to pass a legislative correction to ensure that taxpayers could raise section 6015 claims in district court.

**Curbing Identity Theft**

The growing challenges posed by identity theft made the report’s list of the most serious problems affecting taxpayers. Olson praised the measures the IRS has taken to improve internal management of identity theft cases, including creating the Identity Protection Specialized Unit to partially centralize the management of identity theft cases; creating markers to flag and track the case files of taxpayers who have reported identity theft; and developing for 2009 an IRS-specific affidavit to help substantiate identity theft claims.
New Regulations Likely to Deter Use of Cost-Sharing Agreements

By Lisa M. Nadal — lnadal@tax.org

The revised cost-sharing regulations (T.D. 9441, REG-144615-02) issued by the Treasury Department and the IRS will continue to have a chilling effect on cost-sharing agreements (CSAs) despite the added flexibility introduced in the new rules, David Canale, director of transfer pricing controversy services at Ernst & Young LLP, told Tax Analysts.

The new rules, issued in December in final and temporary form, replace proposed cost-sharing rules issued in 2005. The rules entered into force recently and are subject to transition rules that provide grandfathering for existing CSAs. An additional hearing on the regs is scheduled for April 21, and comments are due by April 6. (For T.D. 9441, see Doc 2008-27341 or 2009 TNT 1-4. For new REG-144615-02, see Doc 2008-27342 or 2009 TNT 1-5; for REG-144615-02, as published in 2005, see Doc 2005-17678 or 2005 TNT 162-1.)

Canale explained that while the new regulations are more flexible than the 2005 regulations, they are still restrictive in terms of how taxpayers can value intangible property transferred in a CSA. He noted that the new rules retain the “investor model” introduced in the 2005 proposed rules as the main approach to evaluate relationships and contributions in a CSA.

In general, the investor model treats each participant in a CSA as having made an investment composed of its share of the intangible development costs incurred on an ongoing basis and any contribution of existing resources and capabilities. Many commentators have criticized the model, saying its valuation principles are too restrictive. The IRS, however, says the investor model “is key to ensuring consistency of the results of a CSA with the arm’s-length standard.”

The investor model ‘is key to ensuring consistency of the results of a CSA with the arm’s-length standard,’ said the IRS.

“It’s all relative,” Canale said, noting that while the added flexibility in the new regs is “good news,” the rules are still very restrictive when compared with the 1995 regulations.

Jake Feldman, executive director of transfer pricing at Grant Thornton, takes a similar view. He acknowledged that the IRS has made improvements and added flexibility with the new regs, but he told Tax Analysts the improvements are “at the edges.”

IRS CLARIFIES NEW DEFERRED COMPENSATION STATUTE

The IRS last week released Notice 2009-8, providing guidance on when employee compensation paid into a nonqualified deferred compensation plan (NDCP) must be included in a taxpayer’s gross income under newly enacted section 457A.

Congress enacted section 457A in October 2008 as part of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (P.L. 110-343). The statute, which took effect January 1, 2009, generally provides that compensation deferred under an NDCP is includable in gross income when the NDCP is operated by a “nonqualified entity” and there is no substantial risk of forfeiture of the rights to receive the compensation. Notwithstanding that general rule, deferred compensation paid into an NDCP can be excluded from gross income if the amount of compensation is indeterminable. (For Notice 2009-8, 2009-4 IRB 1, see Doc 2009-407 or 2009 TNT 5-5. For prior coverage, see Tax Notes, Dec. 15, 2008, p. 1240, Doc 2008-25718, or 2008 TNT 236-1.)

The notice is aimed at identifying which types of NDCPs are subject to section 457A and whether the plan sponsor will be considered a nonqualifying entity. The notice provides 27 examples that detail:

• the definition of a nonqualified entity;
• which plan sponsors are subject to section 457A;
• what is a substantial risk of forfeiture;
• what is the exception for short-term deferral;
• how to calculate the amount includable in gross income; and
• when the amount of compensation is considered indeterminable.

For purposes of section 457A, the terms nonqualifying entity and NDCP have the same meaning as under section 409A(d), subject to minor modifications.

Nonqualified entities include foreign corporations unless substantially all of their income is effectively connected to a U.S. trade or business, and thus taxable in the United States, or is subject to a comprehensive income tax in another country. Nonqualified entities also include partnerships, unless substantially all the partnership income is allocated to persons other than organizations exempt from U.S. taxation and foreign persons not subject to a comprehensive income tax in another country.

— Robert Goulder
Added Flexibility

Canale pointed out that the proposed 2005 rules provided for no grandfathering. Under those rules, any new contribution to a CSA would have brought the CSA into the purview of the cost-sharing rules, even if the CSA existed before the rules were introduced. The new rules, Canale said, provide a facts and circumstances test to determine whether there has been a material change in the scope of the CSA, which would trigger the new rules.

The new rules are also more flexible in terms of dividing the interests in intangible property developed in a CSA. Under the proposed 2005 regs, controlled participants had to have nonoverlapping territorial interests that entitled each controlled participant to the perpetual and exclusive right to the profits in its territory.

The new rules will affect taxpayers with existing CSAs as well as those entering into new ones, Canale said.

In response to criticism about the nonoverlapping, exclusive, and perpetual conditions, the new rules offer another option — the “field of use division of interests” — to qualify divisional interests. Under the field of use option, each controlled participant receives the perpetual and exclusive right to exploit the intangible in an assigned field of use.

The rules also allow for other nonoverlapping divisional interests, provided that the basis used for the division meets four requirements: (1) the basis must clearly divide all interests in cost-shared intangibles among the controlled participants; (2) the consistent use of the basis must be dependable verified from the controlled participants’ records; (3) the rights of the controlled participants to exploit cost-shared intangibles must be nonoverlapping, exclusive, and perpetual; and (4) the resulting benefits associated with each controlled participant’s interest in cost-shared intangibles must be predictable with a reasonable degree of reliability.

The Chilling Effect

Canale explained that the new rules were issued in temporary and final form, so they have the force of law and are effective for 2009, unlike the 2005 regs, which were issued only in proposed form. As a result, the new rules will affect taxpayers with existing CSAs as well as those entering into new ones, he said.

Overall, the fundamental principles of the 2005 regs remain intact, so the chilling effect that started with the 2005 regs will likely continue, although that is probably not the IRS’s intention, Canale said. The new regs make CSAs cost prohibitive, he said, so in many cases, multinational corporations will have to take on all the risk of developing intangibles, rather than sharing the risk with related parties through a CSA.

Feldman said that while the investor model may make CSAs less attractive, viable alternatives are still a subject of debate. Advance pricing agreements are one interesting alternative, he said, explaining that negotiating in advance with the IRS may be a way to arrive at an acceptable result.

The new rules discuss APAs and announce the government’s intention to issue separate guidance on the interaction between an APA and a CSA. The new regulations state that the forthcoming APA guidance will provide an exception to periodic adjustments for transactions covered by an APA.

Kerwin Chung, a director at Deloitte Tax LLP, told Tax Analysts the regulations also are likely to discourage “cashbox” CSAs. A tax alert coauthored by Chung explains that the new rules “effectively continue the IRS’s attack on cashbox cost-sharing participants, while confirming that participants may earn risky returns for performing substantial development functions and bearing development risks.” Chung said he doesn’t think the new regs will have the same chilling effect on noncashbox CSAs.

International Implications

Addressing the global reach of the new cost-sharing regs, Canale noted that there will be “a lot more controversy around the value of the intellectual property that’s being contributed.” He explained that several CSAs are between a U.S. parent and a foreign subsidiary, and the new rules will mean that the foreign subsidiaries may have a higher buy-in, which will increase the number of controversies surrounding valuation.

Given that, Canale said he expects any new CSAs to involve treaty partners so that valuation controversies can be referred to the competent authority.

Other Changes

Another change introduced by the new rules relates to external contributions and reference transactions. In the CSA context, a primary issue is the amount of the buy-in payment or arm’s-length amount that must be paid to the U.S. parent for external contributions. Under the previous rules, external contributions for which compensation was due to the U.S. parent from other controlled participants consisted of the rights in the reference transaction (RT) to “any resource of capability reasonably anticipated to contribute to developing cost shared intangibles.” The RT was a transaction designated in CSA documentation that granted perpetual and exclusive rights in the subject resource or capability.
Commentators complained that the external contribution definition in the previous rules reached items such as goodwill and workforce that should not be classified as compensable, and that the RT concept was overly broad.

The new rules eliminate the RT concept and replace the term “external contributions” with “platform contributions” and the term “preliminary or contemporaneous transaction” with “platform contribution transaction.”

There will be ‘a lot more controversy around the value of the intellectual property that’s being contributed,’ said Canale.

Under the new rules, platform contributions that must be compensated, such as external contributions, are not limited to the transfer of intangibles defined in section 936(h)(3)(B). Platform contributions, however, need be compensated only if they are reasonably expected to contribute to the CSA activity in the payer’s division, and not to any of the payee’s resources, capabilities, or rights that are reasonably expected to benefit only the payee’s operations.

On the elimination of the RT concept, the new rules adopt a rebuttable presumption that the payee provides any resource, capability, or right to the intangible development activity on an exclusive basis.

**NEWS ANALYSIS**

**Eric Holder Could Face Questions Over Tax Firm Prosecution**

By Jeremiah Coder — jcoder@tax.org

It’s no secret that Senate Republicans intend to grill President-elect Barack Obama’s nominee for attorney general, Eric Holder Jr., over his participation in President Bill Clinton’s pardon of tax evader Marc Rich, even though few political observers expect that involvement to doom the nomination. Republicans are merely out to bloody the incoming administration where they can.

But there is more in Holder’s public service folder that could incite fierce questioning. Back when he was deputy attorney general in the Clinton administration, Holder issued a policy memo on corporate prosecutions that would later generate significant disapproval from some members of Congress.

Aspects of the now infamous government prosecution of KPMG have roots that spread back to a 1999 memo Holder wrote on bringing criminal charges against corporations. The foundations laid out in that document were repeated in various iterations prepared by succeeding deputy attorneys general. The legal community now generally refers to them as the Thompson, McNulty, and Filip memos. Holder’s memo listed factors to be considered when determining the level of cooperation from a corporation under threat of prosecution. Factors included the corporation’s willingness to waive attorney-client and work product privileges and the advancement of legal fees to “culpable employees.” That approach proved damaging to the government.

As deputy attorney general, Holder issued a policy memo on corporate prosecutions that would later generate significant disapproval from some members of Congress.

What eventually doomed much of the government’s case against former KPMG employees alleged to have peddled fraudulent tax shelters was the firm’s withholding of legal fees to its indicted partners and managers. U.S. District Court Judge Lewis A. Kaplan eventually dismissed charges against 13 KPMG defendants after finding that government coercion of KPMG resulted in constitutional violations of the indicted individuals’ rights to due process and counsel. The Second
Circuit affirmed. (For prior coverage of United States v. Jeffrey Stein et al., see Tax Notes, Jan. 5, 2009, p. 42, Doc 2008-27137, or 2009 TNT 2-9.)

In response to the brouhaha over the Justice Department’s tactics, several senators expressed outrage and tried to enact legislation that would have strengthened attorney-client privilege rights for corporate employees. Sen. Arlen Specter, R-Pa., ranking minority member of the Senate Judiciary Committee, introduced the Attorney-Client Privilege Protection Act of 2007 (S. 186), which would have done away with much of the McNulty memo.

Would having Holder at the helm of the Justice Department bring back the specter of Stein and produce terror in the tax community? Most sources contacted by Tax Analysts think not.

Bryan Skarlatos of Kostelanetz & Fink LLP in New York said he doubted Holder’s work on the 1999 corporate prosecution memo would become a lightning rod during his confirmation hearing. “Mr. Holder could be taken to task for what he meant in the memo and how far he intended to push,” Skarlatos said, but there is little likelihood it will become a game-changer. “I like to think that Mr. Holder realizes that the government should use more finesse and discretion when investigating corporations and their employees for alleged abuses,” he said.

"The government learned you can't unfairly gain leverage over someone else; you have to look at the merits of what they did," said Skarlatos.

David H. Laufman, a partner in the Washington office of Kelley Drye & Warren LLP and a former DOJ official, said that the Holder memorandum is unlikely to be a significant issue. “Mr. Holder likely will be asked about the memo, particularly given Senator Specter’s strong interest in the subject,” he said, “but I doubt it will be an impediment to his confirmation.”

Acknowledging the sea change in attitude toward corporate prosecutions of accounting firms and tax advisers at Justice, Skarlatos predicted that a reprisal of the KPMG fiasco is highly unlikely. “The Justice Department has probed the extent to which you can motivate certain behavior in extracting concessions,” he said. “In the future, Justice will be more sensitive, because the spectacular backfire from KPMG demonstrated an aggressiveness that was inattentive to everybody’s rights. The government learned you can’t unfairly gain leverage over someone else; you have to look at the merits of what they did.”

So, expect the main focus of the hearing to be the Rich pardon, although that single instance isn’t likely to inform how Holder might approach tax work at the DOJ. One former Justice official said, “I would like to think that Mr. Holder’s advice on the pardon does not reflect disrespect for the important work of the Tax Division.”

Several sources contacted by Tax Analysts said that the absence of public discussion about possible candidates to head the Tax Division could be an indication that Obama is waiting for the first wave of nominations to make it through the Senate confirmation process before filling in the Justice Department’s remaining empty slots.
IRS Willing to Work With Economically Distressed Taxpayers

By Michael Joe — mjoe@tax.org

Expecting more and more Americans to have trouble paying taxes in tough economic times, the IRS announced last week that taxpayers in financial hardship may be eligible for a temporary suspension of collection actions against them and could be allowed to skip a payment on installment agreements and offers in compromise.

“I’ve instructed all personnel at the IRS to be sensitive to taxpayers, especially previously compliant taxpayers who are for the first time having a hard time paying the IRS,” IRS Commissioner Douglas Shulman said in a conference call with reporters.

“But the only way we are going to be able to work with people is if they reach out and talk to us,” Shulman added. “If someone just doesn’t pay their taxes, doesn’t file, doesn’t make an installment payment, they are going to get in trouble with the government.”

Shulman did not offer detailed criteria for suspending collection actions, but he noted that if a taxpayer has recently lost a job or faces large medical bills, the Service may be able to suspend collection actions without a requirement that the taxpayer supply documentation. (For a related IRS release, see Doc 2009-146 or 2009 TNT 3-5.)

Taxpayers with existing installment agreements may be allowed to miss a periodic payment or reduce their payments without automatically suspending the agreement. Similarly, taxpayers engaged in OICs, which are agreements taxpayers make with the IRS to settle their tax debts for less than the full amount, may be eligible to miss a payment without defaulting on the OIC.

Asked how many payments a taxpayer might be allowed to miss, Shulman did not commit to a number. Instead, he suggested that the IRS will be flexible, but added that the limit may be only one payment.

“We’re going to work with taxpayers who have legitimate needs,” Shulman said. “We’ve instructed people, at this point, that one missed payment is not enough to get rid of an installment agreement or an OIC. The important thing is for people to pick up the phone.”

Shulman also said the IRS recognizes that a closer review may be justified for taxpayers who seek an OIC with the IRS but who have been rejected because they show enough equity in their home to pay the tax debt.

Noting that the housing crisis at the center of the economic slowdown has left home equity values in flux, Shulman said the IRS has established a special unit of experts to take a second look at OICs rejected because taxpayers had too much home equity. (For prior coverage, see Tax Notes, Dec. 22, 2008, p. 1362, Doc 2008-26679, or 2008 TNT 245-1.)

“Sometimes that piece of paper that says your home is worth a certain amount may or may not be true because of local real estate situations,” Shulman said.

KERIK PLEADS NOT GUILTY TO INTERFERING WITH TAX ADMINISTRATION

Bernard Kerik, former police commissioner for New York City and former U.S. interim minister of interior of Iraq, pleaded not guilty in December to charges that include obstructing the administration of the IRS.

Kerik gained national prominence in 2004 as President Bush’s nominee to replace Tom Ridge as the homeland security secretary. He withdrew from the nomination process because he had employed an illegal immigrant as his children’s nanny.

The indictment, filed on December 2, 2008, supersedes a November 8, 2007, indictment that made similar claims that Kerik “corruptly obstructed and impeded, and attempted to obstruct and impede, the due administration of the Internal Revenue laws.” Among the acts cited in the indictment are filing false tax returns, taking fraudulent deductions, failing to report income, and providing false information to his accountants.

The indictment alleges that Kerik failed to timely report more than $587,000 in income from 1999 to 2003 and that he took at least $80,000 in fraudulent deductions.

Kerik is also accused of failing to report the wages of his children’s nanny and of failing to remit employment taxes on those wages to the IRS.

The case is United States of America v. Bernard B. Kerik, 07-cr-1027 (S.D.N.Y).

— Sam Young
Also, IRS officials on the conference call said that taxpayers in economic hardship who seek an expedited release from a levy imposed on a bank account or wages for taxes due may be helped by an easing of requirements. Levy releases may be granted by IRS officials over the telephone, but, the IRS said, taxpayers should be prepared to provide the Service with the fax number of the bank or employer processing the levy.

'Sometimes that piece of paper that says your home is worth a certain amount may or may not be true because of local real estate situations,' Shulman said.

Shulman and the other IRS officials also highlighted a new option to boost the number of taxpayers who file returns electronically. The Service is offering free filing to taxpayers who would otherwise not be eligible for the IRS’s established Free File program because their adjusted gross incomes are too high.

Only those taxpayers with AGIs of $56,000 or less are eligible for free electronic return preparation and filing. But this season, the IRS is offering a new option through the IRS Web site for those with higher incomes.

Called Free File Fillable Tax Forms, the new option makes available online common tax forms and schedules and allows taxpayers to fill out and file them electronically. Unlike Free File offerings, however, the new option does not include an online interview procedure, Shulman said. But it does allow the taxpayer to do basic math calculations, enter tax data, sign the returns electronically, and print the returns.

IRS planners think this free e-filing offer might be attractive to taxpayers who are comfortable with the code, have simpler returns, or prepare the return using tax preparation software.

House Approves Rules Package Easing Pay-Go Requirements

By Chuck O'Toole — chuck_o'toole@tax.org

House Democrats last week gave themselves a big escape clause from the strictures of “pay as you go” budget rules.

On the first day of the 111th Congress, the House voted largely along party lines, 242 to 181, to adopt H. Res. 5, a set of changes to the rules governing House procedures. Included in the resolution is new language that would automatically waive the pay-go requirement for any spending or revenue bill “expressly designated as an emergency” measure. H. Res. 5 also expands on earmark reforms passed in the 110th Congress, ends term limits for House committee chairs, and eliminates the ability of the minority party to kill bills on the floor by sending them back to committee for indefinite consideration. (For a fact sheet on the rules package, see Doc 2009-172 or 2009 TNT 3-29.)

The rules package prompted strong objections from House Republicans. In an open letter to his GOP colleagues, House Rules Committee ranking minority member David Dreier, R-Calif., accused Democrats of “avoiding the tough decisions on pay-go.”

“No longer will the Democratic majority have to struggle with finding the votes to waive pay-go when fixing the alternative minimum tax or bailing out another failing company,” Dreier wrote. “They simply declare an emergency, and pay-go doesn’t apply.” (For the letter, see Doc 2009-169 or 2009 TNT 3-31.)

In floor remarks, House Majority Leader Steny H. Hoyer, D-Md., did not address the new “emergency” designation directly, but said the pay-go rules “confirm our commitment to fiscal responsibility.”

Under the House rules for the 110th Congress, members could raise a point of order against any legislation that increased the budget deficit or decreased the budget surplus. A successful point of order would effectively kill the bill. The point of order could be waived for specific bills by a special rule passed by the House Rules Committee and approved by the full House, a process that would happen only with the support of House majority leadership. The 110th Congress used that procedure to waive pay-go for several tax bills, including the one-year “patch” of the alternative minimum tax for the 2007 tax year and the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), which included a partially offset $150 billion set of tax breaks.
The new “emergency” designation lets House leaders bypass debate over the pay-go point of order, streamlining the legislative process but weakening a check against deficit spending.

House Democrats are considering waiving pay-go on several major bills in the new Congress, beginning with the economic stimulus package that President-elect Barack Obama has requested. (For related coverage, see p. 182.) Across the Capitol, Senate taxwriter and Budget Committee Chair Kent Conrad, D-N.D., suggested that the economic crisis “is way beyond tactical approaches” such as pay-go, and instead suggested that Congress would have to alter its method of dealing with the national debt to achieve fiscal health. “This problem requires fundamental policy change,” he said. Even as his team is assembling the stimulus bill, which could add hundreds of billions of dollars to the deficit, Obama told reporters last week that he is “troubled” by the country’s long-term fiscal health.

“Potentially we’ve got trillion dollar deficits for years to come, even with the economic recovery that we are working on at this point,” Obama said, adding, “I’m going to be willing to make some very difficult choices in how we get a handle on this deficit.”

**HOUSE TO VOTE ON SCHIP BILL CONTAINING TOBACCO TAX INCREASE**

The House will revive a popular children’s health insurance bill — and a proposal for higher tobacco taxes to pay for it — this week, according to a House leadership aide.

Congress in 2007 twice passed legislation to reauthorize and expand the State Children’s Health Insurance Program (SCHIP), with strong bipartisan majorities. Both times President Bush vetoed the bills. Democrats were unable to win enough Republican votes to override the vetoes, so the program was extended through a continuing resolution set to expire in March. (For prior coverage, see Tax Notes, Jan. 28, 2008, p. 453, Doc 2008-1392, or 2008 TNT 16-5.)

The most recent bill would have offset the cost of SCHIP expansion by increasing the tax on a pack of cigarettes 61 cents and raising the cap on taxes for large cigars to $3. The leadership aide said the tax provisions in the new bill were expected to remain the same.

House Democratic leaders have said that they have not set a date for a vote on the bill, but that it will take place sometime in the next week. With stronger control over Congress and a sympathetic new administration, Democrats expect the bill to pass easily through both chambers and be signed into law shortly after President-elect Barack Obama becomes president.

— Chuck O’Toole
Recession to Take Big Bite Out of Tax Revenues, CBO Says

By Chuck O’Toole — chuck_otoole@tax.org

The ongoing recession will hammer federal tax revenues in fiscal 2009, contributing to a $1.2 trillion deficit for the year, the Congressional Budget Office said in its annual budget and economic outlook released last week.

The CBO — the official, nonpartisan budget watchdog for Congress — projected that total revenues will fall by $166 billion, or 6.6 percent, in fiscal 2009, as corporate profits and wages shrink in the tightening economy. (For the report, see Doc 2009-236 or 2009 TNT 4-23.)

The CBO projected that total revenues will fall by $166 billion, or 6.6 percent, as corporate profits and wages shrink in the tightening economy.

The report estimates that revenue from individual income taxes will fall to $1.06 trillion in fiscal 2009, a decrease of $86 billion, or 7.5 percent, compared with the previous year. Corporate income tax revenue will plunge to $223 billion in fiscal 2009, a fall of $81 billion, or nearly 27 percent, compared with fiscal 2008. Payroll tax revenues will rise slightly over the same period, the report says. It projected those revenues to rise to $915 billion in fiscal 2009, from $900 billion the previous year. Meanwhile, tax revenues from realized capital gains are projected to drop by $55 billion, or by more than 40 percent, while other tax revenues will fall by a combined 7.5 percent to $160 billion.

Overall, revenues are projected to fall to 16.5 percent of GDP in 2009, one of the lowest shares of GDP since 1959. In the last 50 years, revenues have averaged slightly more than 18 percent of GDP.

The revenue shortfall is one factor contributing to an estimated $1.2 trillion budget deficit for fiscal 2009, equivalent to 8.3 percent of GDP. Real GDP will shrink by an estimated 2.2 percent in that period, the CBO predicted.

In early September 2008, the CBO estimated that the fiscal 2009 deficit would reach only $438 billion, but that was before the credit crunch and the federal takeover of mortgage giants, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (Fannie Mae and Freddie Mac, respectively), and subsequent emergency spending and tax cut bills.

Deficit Underestimated

The $1.2 trillion figure more than likely underestimates the true deficit because it is based on current law and policy. The figure therefore does not include ongoing expenses from the wars in Iraq and Afghanistan, which have been funded on an emergency basis outside the budget process since the conflicts began.

The CBO figure also omits the cost of an economic stimulus package that the transition team of President-elect Barack Obama is expected to introduce in the coming days. Experts estimate that package could add anywhere from $700 billion to more than $1 trillion to the deficit over two years. (For related coverage, see p. 182.)

The CBO projects that the deficit picture will start to improve in 2010, shrinking to a mere $188 billion in 2018. But that relatively rosy outlook again assumes that current law will be unchanged, meaning that the tax cuts passed in 2001 and 2003 will expire on schedule at the end of 2010, and that the alternative minimum tax will return to full effect starting in 2009.

In fact, Obama has proposed extending several of the 2001 and 2003 cuts indefinitely, and many observers expect that the AMT will either be patched again or substantially reworked in the coming years to reduce its impact on middle-income taxpayers.

Lawmaker Reaction

On Capitol Hill, the budget figures prompted similar expressions of shock from both sides of the aisle, yet very different conclusions about policy.

The CBO projects that the deficit picture will start to improve in 2010, shrinking to a mere $188 billion in 2018.

Democrats laid the blame for the grim report at the feet of the Bush administration. Senate taxwriter and Budget Committee Chair Kent Conrad, D-N.D., told reporters the upcoming stimulus bill should include a framework for long-term reduction of the national debt. He also called for reform of what he termed an “outdated, antiquated revenue system” by shutting down tax “scams” and offshore tax havens.

In a briefing with reporters, House taxwriter and Budget Committee ranking minority member Paul Ryan, R-Wis., noted that the trillion-dollar deficit came “before passing a single bill” in the new Congress, and suggested that the business climate was hampered by the coming expiration of the 2001 and 2003 tax cuts.
“What we know doesn’t work [to spur the economy] is a 33 percent increase in capital gains taxes,” Ryan said, referring to the scheduled increase of the long-term capital gains tax rate from 15 percent to 20 percent. He and Senate Budget Committee ranking minority member Judd Gregg, R-N.H., said Congress should encourage job growth by making permanent cuts in taxes paid by small businesses.

Obama’s ‘Performance Officer’ Brings Experience From Treasury

By Nicole Duarte — nduarte@tax.org

Nancy Killefer, newly named as President-elect Barack Obama’s White House “performance officer,” brings extensive experience with IRS restructuring to her task of coordinating and evaluating the efficiency of federal agencies.

Killefer served in the Clinton administration’s Treasury Department during the IRS’s restructuring process and later served as a charter member of the IRS Oversight Board.

“This is a really good thing for the IRS,” Jeff Trinca, a chief of staff of the IRS restructuring commission who worked with Killefer during her time at Treasury, told Tax Analysts. (For prior coverage, see Tax Notes, July 28, 2008, p. 300, Doc 2008-15938, or 2008 TNT 140-3.)

Killefer and IRS Commissioner Douglas Shulman “speak each other’s language,” added Trinca, currently a vice president of the lobbying firm Van Scoyoc Associates in Washington. “There’s going to be a great deal of respect and ability for [Shulman] to make his case at the highest level for the resources he needs.”

“She’s familiar, on an up-to-date basis, with the IRS,” Robert M. Tobias, director of public sector executive education at American University, told Tax Analysts. Tobias served as the president of the National Treasury Employees Union during Killefer’s tenure at Treasury and was another charter member of the IRS Oversight Board.

Still serving on the Oversight Board, Tobias noted that Killefer’s current employer, consulting firm McKinsey & Co., was recently under contract with the IRS to assist the Service in creating its soon-to-be-released 2007-2012 strategic plan. Killefer was part of the McKinsey team working on the plan, he said.

Killefer’s Restructuring Role

From 1997 to 2000, Killefer served in several positions in the Treasury Department, notably as assistant secretary for management. While at Treasury, she was instrumental in helping the IRS reorganize itself under the auspices of the Internal Revenue Service Restructuring and Reform Act of 1998. In 2000 Killefer became one of the charter members of the newly formed Oversight Board, and became the board’s second chairperson in 2002.

“She understood the IRS,” Tobias said. “When you’re starting a new organization like the Oversight Board, you have to create a whole new set of relationships. Treasury was wary of the Oversight Board, the IRS was wary of the Oversight Board.”
Tobias added, “She was very wise about understanding and being sensitive to that, while recognizing that the board had a real role and responsibility.”

Former IRS Commissioner Charles O. Rossotti worked closely with Killefer for about three years during the IRS’s restructuring process. “She was instrumental in making the whole restructuring process work,” Rossotti, now senior adviser with the Carlyle Group, told Tax Analysts. “Almost everything that was done on restructuring I did in close consultation with her.”

Such were Killefer’s collaboration skills, Rossotti said, that the two were able to make something productive out of the strained relationship that Treasury and the IRS experienced at the beginning of the restructuring process.

As a result, Rossotti said, he and Killefer were able to facilitate collaborative efforts to modernize the IRS’s computer systems, reorganize the internal structure of the agency, and change the way employee performance was measured.

“You can’t just shuffle boxes around on a flow chart; you have to change the attitude and the culture in an organization,” said Trinca.

Tobias credits Killefer with sponsoring two major initiatives during restructuring: the effort to simplify the notices that taxpayers receive from the Service, and the effort to prioritize improved service to taxpayers alongside enforcement.

“Most of the substantive attempts at reform came out of Killefer’s office,” said Trinca, who also credits her with translating the work of the IRS restructuring commission to Clinton Treasury Secretary Larry Summers and other political leaders.

Building Bridges

Rossotti said Killefer’s role at Treasury was in some ways comparable to what she might be doing now, “just on a bigger scale.” Rossotti and Killefer moved Treasury and the IRS “from an arms-length adversarial relationship to where we were working as a team to decide what the right things were to do and to get them done,” Rossotti said, adding, “I anticipate she will take the same approach with other agencies.”

Killefer is familiar with the problem of measurement in an agency, Tobias said. One of her first and most important tasks will be to decide how to measure efficiency and effectiveness in outcomes as well as to provide data to decision-makers on a timely basis.

Trinca added that “she’s going to understand better than anyone how difficult it really is to make fundamental changes in an agency. You can’t just shuffle boxes around on a flow chart; you have to change the attitude and the culture in an organization. There’s not an agency out there with a stronger culture than the IRS.”

Trinca noted that it will be up to the president-elect to decide how important Killefer’s role is and whether she will speak for Obama. If that’s the sense the agencies get, things will get done, he said.

Trinca was hopeful about Killefer’s prospects. If the position is modeled after former Vice President Al Gore’s efforts to reinvent government initiative, “then I think there could be some real good to come from it. If not,” he said, “it could be one of the things where a few years on, you wonder what the heck ever happened.”
Frank Wants Treasury to Invest in Low-Income Housing Credits

By Chuck O'Toole — chuck_otoole@tax.org

The Treasury Department may shore up the market for low-income housing tax credits, if Congress approves a top House Democrat’s plan.

An aide for Financial Services Committee Chair Barney Frank, D-Mass., recently confirmed that Frank is pushing legislation to let Treasury invest $5 billion in housing projects eligible for low-income housing tax credits. An additional $5 billion would go to states for the same purpose.

The plan would be part of an economic stimulus package that lawmakers are drafting in anticipation of the incoming Obama administration. The Frank aide said that details about the plan were unavailable as staffers continue negotiations.

Frank’s proposal addresses concerns about the so-called tax-equity investment market, in which developers form partnerships with banks or other large institutions to construct and manage low-income housing. In a typical arrangement, a bank provides capital for construction and maintenance of a low-income housing development in exchange for a passive majority (usually greater than 99 percent) stake in the partnership. That ownership stake lets the bank claim the tax credits associated with the project, while the developer recoups construction costs.

Frank is pushing legislation to let Treasury invest $5 billion in housing projects eligible for low-income housing tax credits, said an aide.

But tax-equity specialists and some congressional aides say that the recent economic downturn and the credit crisis affecting major financial institutions have sharply diminished banks’ appetite for tax credits.

Also, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (Fannie Mae and Freddie Mac, respectively), both major investors in low-income housing tax credits, entered government conservatorship in September 2008 and have announced plans to liquidate their tax-preferred investment portfolios. (For prior coverage, see Tax Notes, Nov. 3, 2008, p. 520, Doc 2008-23135, or 2008 TNT 212-2.)

A December report published by the Massachusetts Housing Partnership and Recap Advisors LLC of Boston estimated that the investment demand for low-income housing tax credits has fallen by 60 percent since 2006. As a result, the report says, several projects have stalled as funding has dried up. (For the report, see Doc 2008-27361 or 2008 TNT 1-24.)
Exempts Need More Personal Contact With the IRS, Says Report

By Fred Stokeld — fstokeld@tax.org

The IRS Tax-Exempt and Government Entities Division (TE/GE) is relying heavily on the Internet to provide education and outreach to tax-exempt organizations at the expense of personal contact, according to the National Taxpayer Advocate’s 2008 Annual Report to Congress.

The report, released last week by the Taxpayer Advocate Service, noted that between October 2007 and May 2008 the Exempt Organizations Division, which falls under TE/GE, conducted workshops on the redesigned Form 990, “Return of Organization Exempt From Income Tax,” and on other topics, and that the workshops included face-to-face interactive forums. But most of the division’s education and outreach efforts are conducted through the Internet rather than in person, and officials are more likely to make speeches in response to invitations they receive rather than initiate their own speaking engagements, according to the report.

The report adds that EO officials received fewer speaking requests last year, resulting in a 35 percent drop in the number of customers reached compared with the first quarter of fiscal 2006. (For the executive summary and report, see Doc 2009-241 or 2009 TNT 4-21. For a related IRS news release, see Doc 2009-240 or 2009 TNT 4-10.)

“Electronic taxpayer service should not supplant face-to-face outreach unless EO has data that supports organizations’ preference for these services,” the report says.

In response, the IRS said the EO Division has balanced its Internet outreach with personal appearances by EO Division officials. There are about 1,600 articles on EO topics in the Charities and Nonprofits portion of the IRS Web site, and there has been an 81 percent rise in the use of the Charities and Nonprofits section since fiscal 2005, according to the IRS.

The IRS also said EO Division officials received almost 50 percent more speaking invitations during fiscal 2008, mostly because of interest in the new Form 990 and the Form 990-N, “Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Re-
Retirement Plans

Another simplification proposal will interest EOs and other types of entities that offer retirement plans. It asks lawmakers to consider consolidating some plans and perhaps establish one type of plan for individuals, another for small businesses, and one for large businesses; plans limited to governmental entities would be eliminated.

The report says there should be uniform rules governing hardship withdrawals, plan loans, and portability.

William F. Sweetnam of the Groom Law Group said proposals to simplify the number and types of retirement plans are not new, noting that the Bush administration proposed three types of plans: lifetime savings accounts, retirement savings accounts, and employer retirement savings accounts. He said there has not been much of an effort on Capitol Hill to advance any changes, and he noted that there are influential people and institutions, some of which reflect established constituencies such as teachers, that are happy with the current system.

“Whether a strong constituency emerges to try to advance a major simplification in the number and types of retirement plans is unclear at this time, although we could conceivably see a push for payroll deduction IRAs by the new administration,” Sweetnam said.

Another recommendation involves the mileage deduction for charitable activities. The report notes that the standard mileage deduction for vehicle expenses related to a charitable activity is 14 cents a mile and that the IRS is not empowered to change the rate when conditions, such as higher gas prices, warrant it. The report urges Congress to change the code to allow the IRS to determine the mileage rate.

The mileage proposal is likely to be popular with charities. In November, Diana Aviv, president and CEO of Independent Sector, an umbrella group of nonprofits, said the 14-cent rate had made it difficult for charities to recruit volunteer drivers during periods of fluctuating gas prices. (For Aviv's comments, see Doc 2008-24972 or 2008 TNT 229-34.)
In-House Advertisement
Intentionally Removed
Temporarily Cost-Sharing Regs Uncorked on New Year's Eve

By Joseph DiSciullo — jdisciul@tax.org and
Robert Goulder — rgoulder@tax.org

By the time the ball had begun its descent in Times Square, some transfer pricing practitioners had spent half a day cozying up to more than 200 pages of temporary and proposed cost-sharing regulations issued that afternoon. The preamble to the temporary regs claims that the revised rules offer considerably greater flexibility than proposed regs published in 2005.

A December 2008 revenue procedure provided temporary guidance on the treatment of stock distributions by publicly traded corporations that are real estate investment trusts. That guidance has now been extended to publicly traded regulated investment companies.

Recent agricultural policy legislation affects some tax credits and payments related to the fuel use of alcohol and alcohol fuel mixtures. In response to commentators' concerns about the volume of denaturants that will be treated as alcohol, the Service has released a notice that includes a temporary safe harbor and a transitional rule.

An annual series of eight revenue procedures updates guidance on the issuance of letter rulings, technical advice, and determination letters, as well as user fees and lists of areas in which the Service will not rule.

Finally, the IRS wants to inform financially distressed taxpayers that there are options available for people struggling to meet their tax obligations. A news release that provides valuable information on maximizing refunds also encourages taxpayers to take advantage of several new tax credits and deductions and a major enhancement to the Free File program.

Cost-Sharing Arrangements

Recently released temporary and proposed regulations for determining taxable income from cost-sharing arrangements are intended to address issues that have arisen administering the current regs (T.D. 9441, Doc 2008-27341, 2009 TNT 1-4; REG-144615-02, Doc 2008-27342, 2009 TNT 1-5). The new regs make significant changes to proposed regs originally published in 2005 (REG-144615-02, Doc 2005-17678, 2005 TNT 162-1) and are generally applicable for arrangements that begin on or after January 5, 2009, with transition rules provided for some preexisting arrangements. (For additional coverage, see p. 191.)

Cost-sharing arrangements are contracts between U.S. parent companies and their foreign affiliates under which the former transfer self-developed intangible assets to the latter. As a result, royalty income from the worldwide licensing and commercial exploitation of the intangibles accrues offshore, typically in a low-tax jurisdiction. Absent the reach of the U.S. transfer pricing regime, that foreign-source income would likely not be taxed in the United States until repatriated.

Like the 2005 proposed regs, the new regulations focus on the valuation of the foreign affiliates' buy-in amount. That is, the controlled participant receiving the intangibles must adequately compensate the transferor for its capital investment and know-how "in proportion to its respective shares of reasonably anticipated benefits." Because comparable transactions may be unavailable, the regs generally ask what commercial terms separate, unrelated parties would use if entering into a joint venture for the development of the same property rights for the same market. Specific factors to be considered include how the parties choose to allocate material functions and risks, the expected duration of contractual commitments, the degree of uncertainty in profit potential, and the extent to which other resources necessary to commercial development of the property are contributed or shared.

The new regulations retain the controversial "investor model" that was harshly criticized by commentators when introduced as part of the 2005 regs. The preamble to the new regs, however, claims that the revised rules offer considerably greater flexibility in designing tax-efficient cost-sharing agreements. In response to comments, the temporary regs include additional guidance on the evaluation of the arm's-length results of cost-sharing transactions and platform contribution transactions.

One way the new regulations offer more flexibility is by easing the requirement that controlled participants must receive nonoverlapping territorial interests with perpetual and exclusive rights to profits. Commentators had suggested that the territorial interest requirement was an artificial standard that did not comply with common business practices. The new regulations permit a second option — the "field of use division of interests" — which provides an alternative basis for outlining the authorized rights of controlled participants.

The regs also address the material functional and risk allocations in the context of a cost-sharing arrangement, including the reasonably anticipated duration of the commitments, the intended scope of the intangible development, the degree and uncertainty of profit potential of the intangibles to be developed, and the extent of platform and other contributions of resources, capabilities, and rights to the development and exploitation of cost-shared intangibles.

The IRS noted that if available data of uncontrolled transactions reflect, or may be reliably adjusted to reflect, similar facts and circumstances to a cost-sharing arrangement, they may be the basis for application of a comparable uncontrolled transaction method to value the cost-sharing transaction and platform contribution transaction results. Because of the difficulty of finding data that reliably reflect those facts and circumstances —
even after adjustments — the temporary regs also provide for other methods. Those include the newly specified income, acquisition price, market capitalization, and residual profit-split methods.

Regulated Investment Companies


Section 305(a) provides that gross income generally does not include the amount of any distribution of the stock of a corporation made by the corporation to its shareholders in connection with its stock. Under section 305(b)(1), however, the general rule does not apply to a distribution by a corporation of its stock if the distribution is, at the election of any of the shareholders, payable either in its stock or in property. In that case, the distribution will be treated as a distribution of property to which section 301 applies. The same treatment is required by section 305(b)(2) if the distribution (or a series of distributions of which the distribution is one) has the result of the receipt of property by some shareholders, and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

In Rev. Proc. 2008-68, the IRS said it will treat a REIT stock distribution as a distribution of property to which section 301 applies by reason of section 305(b). Also, the amount of the distribution of stock will be considered to equal the amount of the money which could have been received instead. Rev. Proc. 2009-15 extends the same treatment to RICs.

The temporary guidance applies if the distribution is made by the corporation to its shareholders, the stock is publicly traded on an established U.S. securities market, and the distribution is declared for a tax year ending on or before December 31, 2009. Also, the guidance sets a conditional cash limitation on the amount of money to be distributed in the aggregate to all shareholders. Lastly, provisions in the guidance explain how to calculate the value of distributed shares and how the guidance applies to shareholders participating in a dividend reinvestment plan.

Alcohol Fuel Credit

An IRS notice introduces a temporary safe harbor and a transitional rule to implement recent statutory changes made by the Food, Conservation, and Energy Act of 2008 (Food Act) on the volume of denaturants that will be considered alcohol for purposes of some credits and payments (Notice 2009-6, 2009-3 IRB 1, Doc 2008-27360, 2009 TNT 1-14).

Sections 34, 40(a), 6426(a), and 6427(e) provide tax incentives for alcohol and alcohol fuel mixtures that are sold for use or used as a fuel in specified transactions. For those purposes, Notice 2005-4, 2005-1 C.B. 289, Doc 2004-23794, 2004 TNT 242-6, defines alcohol to have the meaning given to the term in reg. section 48.4081-6(b)(1) of the Manufacturers and Retailers Excise Tax Regulations, except that for purposes of the credit allowed by section 40, alcohol also includes alcohol with a proof of at least 150.

Effective for fuel sold or used after December 31, 2008, the Food Act amended section 40(d)(4) to provide that denaturants included in the volume of alcohol may not exceed 2 percent of the volume of that alcohol, including denaturants. Before January 1, 2009, the limit was 5 percent. The Food Act also added section 6426(b)(5) to apply the same 2 percent limit to claims for alcohol fuel mixtures under sections 34, 6426, and 6427. Regulations issued by Treasury’s Alcohol and Tobacco Tax and Trade Bureau (TTB) indicate that alcohol eligible for withdrawal as fuel alcohol must contain two gallons of denaturant for each 100 gallons of distilled spirits. To satisfy the TTB rule, denaturants included in the volume of fuel alcohol must exceed 1.96 percent of the volume of the fuel alcohol.

Commentators have expressed concern about the ability to meet TTB’s 1.96 percent minimum requirement while not exceeding the Food Act’s maximum 2 percent denaturant allowance. They also noted that there is no test procedure to accurately measure the amount of denaturant in alcohol after it has been denatured. As a result, ethanol producers and blenders have no reliable way of determining when denaturants exceed the 2 percent limit. Commentators also wondered how to treat alcohol containing 5 percent denaturant that is in transit or stored by alcohol fuel blenders on January 1, 2009.

In response to the comments about accurately measuring denaturants in alcohol, the guidance provides a temporary safe harbor to allow time to study whether there are effective ways to test the volume of denaturant in alcohol. Under the safe harbor, the IRS will not challenge a claim for denaturants included in alcohol unless the denaturants clearly exceed the Food Act limit. The guidance specifies the requirements that must be met for the safe harbor to apply.

The guidance also includes a transition rule for January 2009 to provide relief for alcohol already produced and shipped. Under the transition rule, the volume of alcohol for which a credit or payment is allowable may be determined under the rules in effect before January 1, 2009, if the credit or payment is allowable to a person other than the producer of the alcohol and the credit or payment is allowable on account of an event (such as a mixture producer’s sale of an alcohol fuel mixture for use as a fuel) occurring before February 1, 2009.

Annual Procedural Updates

The IRS has published revised procedures for issuing ruling letters, determination letters, and information letters on some issues (Rev. Proc. 2009-1, 2009-1 IRB 1, Doc 2008-27360, 2009 TNT 1-14).


**Assistance for Distressed Taxpayers**

With the commencement of the 2009 filing season, the IRS has announced the availability of several options to help financially distressed taxpayers maximize their refunds and expedite payments, while providing additional help to people struggling to meet their tax obligations (IR-2009-2, Doc 2009-146, 2009 TNT 3-5).

To promote speedy refund delivery, the IRS reminds individuals to file their returns electronically and notes that its free return preparation program — Free File — will be open to nearly everyone, not just taxpayers with adjusted gross incomes of up to $56,000.

According to the IRS, taxpayers in hardship situations may be able to adjust payments for back taxes, avoid defaulting on payment agreements, or possibly defer collection action. The Service is increasing flexibility for missed payments and will speed the delivery of levy releases by easing requirements on taxpayers who request expedited levy releases for hardship reasons.

The IRS is also creating an additional level of review for offers in compromise in which home values may not be accurate. Taxpayers who are unable to meet the periodic payment terms of an accepted OIC will be able to contact the IRS office handling the offer for available options to help them avoid default.

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Julie Brienza and Emily Vanderweide contributed to this column.
In-House Advertisement
Intentionally Removed
Merrill Lynch Cross-Chain Sales Were Redemptions, Not Dividends

By Jeremy Scott — jscott@tax.org

The Tax Court, on remand from the Second Circuit, has again held that a series of transactions conducted by Merrill Lynch were redemptions and not tax-favored dividends. In its initial decision, the Tax Court found that the transactions undertaken by Merrill Lynch were part of a firm and fixed plan to sell a subsidiary and did not qualify for dividend treatment. The Second Circuit agreed with that decision but remanded the case for consideration of Merrill Lynch’s alternative argument regarding constructive ownership, raised for the first time on appeal. The Tax Court disagreed with Merrill Lynch’s position and concluded that stock must be directly held, not indirectly or constructively, to avoid redemption treatment under section 302.

The Eleventh Circuit has affirmed the conviction of an evangelical creationist for failing to pay employment taxes, obstructing tax laws, and structuring transactions to avoid financial reporting laws. The court also affirmed the conviction of the taxpayer’s wife for structuring transactions to avoid financial reporting laws. The couple argued that their indictments were insufficient, that insufficient evidence was introduced to support the convictions, and that the district court erred by adding a sentence to the jury instructions. The couple also challenged their sentence, but the appellate court affirmed, upholding a 10-year prison sentence plus restitution for the husband and a 1-year prison sentence for the wife.

A company operating under the IRS’s private debt collection program is not a “government controlled corporation” for purposes of the Privacy Act, according to a recent holding by the Second Circuit, which affirmed a lower court dismissal. A former employee of the debt collection agency brought suit, alleging that Pioneer Recovery impermissibly photocopied and handled his security clearance package. The Second Circuit rejected the assertion that Pioneer Recovery qualified as a government controlled corporation, which is a necessary element of a Privacy Act cause of action.

Redemptions and Dividends

In a remand decision, the Tax Court recently held that cross-chain sales conducted by Merrill Lynch to sell a wholly owned subsidiary but retain a portion of the subsidiary’s assets do not qualify for dividend treatment under section 302. The Tax Court initially disallowed dividend treatment because the transactions were viewed as part of a firm and fixed plan. For the first time on appeal, Merrill Lynch alternatively argued that the constructive ownership test in section 318 allowed it to treat the proceeds of the transactions as dividends and not as redemptions. The Second Circuit remanded the case for consideration of that theory. The Tax Court again denied dividend treatment, holding that under section 304, it was not required to test for constructive or indirect ownership (Merrill Lynch & Co. et al. v. Commissioner, 131 T.C. No. 19 (Dec. 30, 2008), Doc 2008-27312, 2008 TNT 251-5).

Merrill Lynch is the parent of an affiliated group of corporations that filed consolidated returns for the tax years at issue. ML Capital Resources was a subsidiary of Merrill Lynch. The parent wanted to sell a portion of ML’s business but keep nonleasing assets in the group. As a result, Merrill Lynch decided that before it sold ML, the subsidiary would sell to other corporations in the group the stock of ML’s subsidiaries that were engaged in lending and financial activities or that owned other assets and businesses that were not related to its consumer leasing operations.

In February 1987, Merrill Lynch opened the bidding on ML and in March, ML sold all the stock of five of its wholly owned subsidiaries to other corporations in the Merrill Lynch group. According to the Tax Court, those stock sales constituted cross-chain sales. All parties agreed that those sales were section 304 transactions. In June, Merrill Lynch agreed to sell ML to GATX Leasing Corp.

On its 1987 tax return, the group claimed a long-term capital loss of more than $460 million from the sale of ML stock. It also treated the cross-chain sale proceeds as dividend payments to ML, which in turn increased the group’s basis in its ML stock. That alleged increase in basis allowed the group to recognize a loss on the sale of the ML stock outside the group.

The IRS issued a notice of deficiency, asserting that Merrill Lynch overstated the basis of its ML stock by more than $320 million, the amount of the cross-chain proceeds. The group contested the deficiency before the Tax Court.

The Tax Court held for the IRS in Merrill Lynch I. The court decided that the cross-chain stock sales should be integrated with the later sale of the cross-chain seller, ML, outside the affiliate group. That resulted in a redemption in complete termination under section 302(a) and (b)(3). Because the sales were part of a firm and fixed plan, the Tax Court found redemption treatment most appropriate. Merrill Lynch appealed to the Second Circuit.

The Second Circuit affirmed the Tax Court decision in part in Merrill Lynch & Co. & Subs v. Commissioner, 386 F.3d 464 (2d Cir. 2004), Doc 2004-19204, 2004 TNT 190-14. The appellate court adopted the firm and fixed plan test as the appropriate method for determining whether two transactions conducted at different times may be integrated for the purposes of section 302. It also agreed with the Tax Court’s reasoning and application of that test. However, the Second Circuit remanded the case to the Tax Court because Merrill Lynch raised an alternative argument based on section 318.
On appeal, the group argued that the proceeds should be treated as a dividend regardless of whether the actual and constructive ownership interest of ML was completely terminated because the parent, Merrill Lynch, retained a constructive ownership interest in the purchased subsidiaries after the sale of ML for the purposes of section 302(b)(3).

On remand, Judge L. Paige Marvel considered Merrill Lynch’s new argument for dividend treatment and rejected it, holding that under section 302, only ML’s ownership interest needed to be considered for a transaction to qualify as a redemption in complete termination of an ownership interest. Judge Marvel wrote that the issue before the Tax Court was whether Merrill Lynch’s continuing constructive ownership interest in the subsidiaries that participated in the cross-chain sales “must be taken into account in analyzing the tax consequences” under sections 304 and 302. Under section 304, “the persons in control must actually receive property in exchange for the transfer of their issuing corporation stock to warrant the redemption analysis in section 302.” (Emphasis in the original.) Because the Merrill Lynch parent did not actually receive property, a section 318 construction ownership analysis was unnecessary.

The court did not need to look beyond ML’s ownership of the issuing corporations to consider any additional persons who may have an indirect interest in the issuing corporations under the section 318 attribution rules, according to Judge Marvel. Because ML was the only entity that transferred any stock in the cross-chain sales and it was the only shareholder that received property in exchange for that stock, the analysis ended with ML. Therefore, the Tax Court concluded that redemption treatment was still appropriate under section 302. And therefore, the court affirmed the essence of its earlier decision and sustained the deficiencies against Merrill Lynch because its basis in ML stock was no longer sufficient for it to claim the loss on its original 1987 return.

**Tax Fraud**

The Eleventh Circuit affirmed the convictions and sentences of a husband and wife, the former being a promoter of creationism. The court rejected appeals based mostly on allegations of insufficient indictments and evidence. A district court in Florida convicted the husband of failing to collect and withhold employment taxes, obstructing tax laws, and structuring transactions to avoid financial reporting losses. It sentenced him to 10 years in prison plus restitution. The wife was convicted of structuring transactions to avoid financial reporting losses and was sentenced to 1 year in prison. (United States v. Kent E. Hovind et al., No. 07-10090 (11th Cir. Dec. 30, 2008), Doc 2008-27364, 2009 TNT 1-19).

The Hovinds owned and operated Creation Science Evangelism Enterprises, which sold videos and literature, provided lecture services, and hosted debates about creationism and evolution. Between 1999 and 2003, the couple withdrew from AmSouth Bank more than $1.5 million in increments of less than $10,000 to avoid federal filing requirements. Mrs. Hovind controlled the finances of the company and Mr. Hovind oversaw payroll and related federal tax obligations. Mr. Hovind failed to withhold or pay quarterly federal withholding taxes between 2001 and 2003.

The Hovinds were charged in a 58-count indictment. Mr. Hovind was charged with willfully failing to deduct and pay withholding taxes and obstructing the administration of internal revenue laws. Both were charged with 45 counts of structuring cash withdrawals to avoid financial reporting obligations. The indictment included a provision requiring that the Hovinds forfeit all property associated with the reporting crimes or other property up to the value of the associated property.

During the trial, the Hovinds moved for an acquittal on the basis that the government could not prove that each withdrawal equaled or exceeded $10,000. The government, and the district court, believed that the structuring statutes necessarily required a transaction under $10,000. The district judge went so far as to instruct defense counsel that they would not be permitted to argue their interpretation of the structuring statute.

The Hovinds were found guilty of all charges. The jury also entered a special verdict finding $430,000 in property traceable to the reporting crimes and ordered the forfeiture of real or personal property in that amount. The presentencing reports calculated that the tax liability attributed to Mr. Hovind’s crimes amounted to more than $600,000. Initially, the presentencing report recommended a sentence of 97 to 121 months for Mr. Hovind, and 0 to 6 months for Mrs. Hovind. However, the government later learned that the Hovinds had transferred the $430,000 in property related to the reporting crimes to a third party. As a result, the court sentenced Mr. Hovind to 120 months of imprisonment and restitution exceeding $600,000 and sentenced Mrs. Hovind to one year and one day of imprisonment.

The Hovinds raised several issues on appeal relating to the sufficiency of their indictment, the evidence against them, and the jury instructions in the case. The Eleventh Circuit rejected each of these in turn. Mr. Hovind argued that the indictment failed to state what part of Title 26 required him to collect and pay federal withholding taxes and that it failed to define how he acted willfully. The court disagreed that those omissions were material, stating that Mr. Hovind “was adequately notified of his offenses to prepare a defense and to plead double jeopardy in any future prosecution for the same offense.” The trial judge also said the indictment clearly laid out the Hovinds’ reporting crimes. Like the district court, the Eleventh Circuit did not accept the Hovinds’ interpretation that each transaction needed to equal or exceed $10,000. Finally, the appeals court rejected Mr. Hovind’s argument that he did not obstruct the administration of the tax laws because he used legal means. “Acts that might otherwise be legal become corrupt and obstructionist when they are used to ‘thwart the efforts of government officers and employees in executing the laws enacted by Congress.’” The court believed that Mr. Hovind’s legal filings and other activities sufficiently warranted an indictment for this offense.

The Eleventh Circuit also rejected the Hovinds’ contentions that the evidence was insufficient, both in establishing willful intent and knowledge of the tax laws. The court circuit believed that the government adequately
showed Mr. Hovind’s evasion of the withholding tax laws and that the Hovinds structured the cash withdrawals to avoid federal reporting requirements.

The final argument by the Hovinds related to a sentence added to the jury instructions by the court. The district court’s addition was designed to counter the Hovinds’ argument relating to the $10,000 requirement for the structuring statute. According to the appeals court, “the district court was entitled to revise the jury instructions in this manner.” The appeals court also upheld the Hovinds’ sentences, finding no errors by either the jury or the district court. The entirety of the opinion, then, affirmed the district court’s determinations and the jury verdict.

Private Debt Collectors as Government Actors

A firm working under the IRS’s private debt collection program is not a government controlled corporation for purposes of the Privacy Act, according to a Second Circuit ruling last week that affirmed a district court’s dismissal of the case. A former employee of Pioneer Recovery alleged that its handling of his security clearance package violated the Privacy Act. However, to state a cause of action under the Privacy Act, the employee must show that the employer was a government controlled corporation. Both the district court and the Second Circuit did not believe that the employee had made a plausible claim in that regard (Stewart Burch v. Pioneer Credit Recovery Inc., No. 07-2963 (2d Cir. Dec. 22, 2008), Doc 2008-27293, 2008 TNT 251-8).

Stewart Burch was an employee of Pioneer Recovery. Pioneer Recovery was a third-party debt collection agency that provided collection services for the IRS and several other government agencies. Employees of Pioneer Recovery were required to complete security clearance packages. In October 2006, after his employment with Pioneer Recovery had ended, Burch brought a suit claiming that Pioneer Recovery was photocopying his security clearance packages, keeping a permanent record of them in his personnel file, and otherwise mishandling his private and personal information. The district court dismissed his case and he appealed to the Second Circuit.

On appeal, Burch argued that Pioneer Recovery was a government controlled corporation subject to the Privacy Act. He also argued he should have been accorded further discovery and an opportunity to amend his complaint. Noting that the case was an issue of first impression for the Second Circuit, the court considered each of his arguments in turn.

The Second Circuit, like many of the other appellate courts, has held that the private right of civil action created by the Privacy Act is limited to actions against agencies of the U.S. government. An agency of the government can include government controlled corporations, although there is no definition of that term in the Freedom of Information Act or the Privacy Act. However, the court found Burch’s connections between the federal government and Pioneer Recovery to be “weak,” consisting only of the fact that Pioneer Recovery had contracts with the government, that Pioneer Recovery’s employees must complete security clearance packages, and that Pioneer Recovery made its records available to the government. The court wrote that those factors did not amount to “a sufficient level of oversight, supervision, and government connection to lead us to believe that Pioneer should be considered an agency.” For that reason, the Second Circuit upheld the district court’s dismissal on the basis that Burch had failed to state a claim on which relief could be granted. Accordingly, seeing no reason to allow Burch additional discovery or leave to amend his complaint, the Second Circuit affirmed the district court’s dismissal in full.
In-House Advertisement
Intentionally Removed
NYSBA Tax Section Examines Proposed Deemed Asset Sale Regs

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Section 336(e) on deemed asset sales was enacted in large part to prevent the triple tax that would arise when the stock of a target corporation is sold, exchanged, or distributed and both the target corporation’s assets and its shares have increased in value. The New York State Bar Association (NYSBA) Section of Taxation says new proposed regs are an excellent first step toward implementing the provision, but the 113-page report on the regs submitted by section members seems to indicate there is considerable room for improvement.

The NYSBA tax section also examines a bill introduced in the House that would address foreign deferred source income and foreign tax credits and reduce corporate income tax rates. The tax section focuses on “whether the provisions as drafted would successfully achieve their intended purpose, whether they would be likely to produce unintended consequences, and whether they would be reasonably easy to administer.”

Proposed guidance on protected cell companies has presented the American Bar Association Section of Taxation with an opportunity to make recommendations on the entity classification of a type of limited liability company. The guidance asked for comments on whether a cell of a protected cell company should be treated as an insurance company separate from any other entity, but also invited submissions on similar arrangements that do not involve insurance.

Two charitable planning groups point out that recent legislation to assist workers and retirees has an unintended adverse effect on donations made from IRAs. The organizations have submitted a proposal they say will stimulate the economy and provide “positive revenue for housing assistance, feeding the hungry, jobs retraining, education, medical services, and thousands of services” American citizens need today.

Deemed Asset Sales

The NYSBA tax section has submitted comments on proposed regulations on deemed asset transfers under section 336(e) (REG-143544-04, Doc 2008-18199, 2008 TNT 165-5), suggesting some improvements to the regs and that their scope be significantly expanded (Doc 2008-27340, 2009 TNT 1-21).

The proposed regs are intended to provide relief from the potential multiple taxation of the same economic gain that can result when a transfer of appreciated stock is taxed to a corporation without providing a corresponding step-up in the basis of the assets of the corporation. The regs would let a domestic corporation elect to treat qualified dispositions of another corporation’s stock as taxable sales of that corporation’s assets.

The tax section recommends that the proposed model for deemed transactions involved in a section 355(d) or (e) transaction be eliminated. Section members also suggest that the loss disallowance rule either be removed entirely or revised to allow the recognition of built-in asset loss to the extent of built-in asset gain.

Members believe the section 336(e) election should generally be available in the case of a disposition of target corporation stock that is part of a section 351 transaction or in the case of a disposition of target corporation stock governed by section 354 or section 356. In the case of an intragroup disposition of stock followed by a sale of a target corporation in which a section 336(e) election is made, the tax section requests confirmation that reg. section 1.1502-13(f)(5) elective relief is available.

The tax section also requests that the related-party test of section 338 be modified by eliminating attribution from a partner to a partnership and from a partnership to a partner if the partner’s interest in the partnership is less than a specified level. Further, members say partnership attribution should not apply if the partnership itself does not bear an economic relationship to the sale transaction.

Members also suggest that the section 336(e) election should be made by the seller and the target corporation jointly in a time and manner generally consistent with the provisions of section 338, at least for cases in which the seller and the target corporation do not file a consolidated return. Finally, the tax section urges that the election be made available for acquisitions of target S corporations, foreign sellers, and foreign target corporations.

Foreign-Source Income

The NYSBA tax section also sent to Congress last month a report on H.R. 3970, the Tax Reduction and Reform Act of 2007, concerning provisions relating to foreign deferred-source income, foreign tax credits, denial of treaty benefits, and corporate tax rate reductions (Doc 2008-27152, 2008 TNT 249-24).

The proposed legislation includes a wide variety of provisions affecting individuals and businesses, but the tax section’s comments are focused on three aspects of the bill. First, the law would add sections 975 and 976 to the code, requiring deferral of deductions allocable to deferred foreign-source income and changing the rules for calculation of the foreign tax credit to prevent the maximization of credits by selectively recognizing or repatriating high-taxed foreign income. Members say the bill should clarify that the new sections apply on an affiliated groupwide basis, the definition of deferred foreign income should be clarified and expanded, foreign withholding taxes imposed on dividends should be creditable in the year the dividends are received, and rules should be added to determine the effect on a U.S.
The table below lists the dates by which written comments on proposed regulations must be received by the Service. Comments should be sent to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044, Attn: CC:DOM:CORP:T:R (IRS file number, as indicated in the table).

The last column contains citations to summaries of the proposed regs in Tax Notes, as well as document (Doc) numbers, and Tax Notes Today (TNT) citations to the full text of the proposals.

<table>
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(Unless otherwise noted, all dates are 2009.)

affiliated group’s previously deferred foreign income, deductions, and foreign income taxes when a member leaves the group.

Also, section members urge reconsideration of the bill’s treatment of interest and royalty payments received by a U.S. taxpayer as currently taxed foreign income. Further, members think the section 905(c) regs on the effect of redeterminations of foreign tax liability should be modified to reflect that the proposed law does not differentiate between foreign taxes paid directly by a U.S. taxpayer and foreign taxes paid by controlled foreign corporations. The tax section also stresses the importance of issuing additional guidance “in the form of legislative history or administrative pronouncements so that taxpayers fully understand the impact of the bill before it becomes effective.”

The second area of discussion is the addition of a new section 894(d) that would limit treaty benefits for some related-party deductible payments received by members of a foreign-owned controlled group. Section members note that the provision is intended to prevent treaty shopping and thus promotes valid policy objectives, but may be underinclusive by not applying when “the foreign common parent corporation is organized in a treaty country that has a broad participation exemption under its domestic law, even though those situations can produce similar results to structures where the parent is organized in a tax haven jurisdiction with no treaty.” Members also question the effectiveness of the proposed provision because it would apply only if the U.S. payer and the foreign recipient are controlled by a foreign common parent corporation.

The third topic examined by the tax section is the effect of a reduction in corporate income tax rates. Members warn that if the corporate rate falls below the highest individual tax rate, corporations could once again become vehicles for wealthy individuals to shelter their income, particularly if the rate differential becomes sufficiently large. In that case two seldom-used mechanisms to prevent tax avoidance — the accumulated earnings tax and the personal holding company tax — could gain renewed relevance.

**Protected Cell Companies**

The ABA tax section, responding to proposed guidance for determining whether an arrangement between a participant and cell of a protected cell company is insurance for income tax purposes (Notice 2008-19, 2008-5 IRB 366, Doc 2008-844, 2008 TNT 11-6), has submitted recommendations for the treatment of some LLCs (Doc 2009-115, 2009 TNT 2-56). In particular, the tax section is responding to the Service’s request for comments on segregated arrangements that are similar to protected cell companies but that do not involve insurance.

Delaware law permits the creation of a single LLC with separate series, or units, of members, managers, LLC interests, or assets. Thus, a so-called series LLC that buys individual pieces of real estate may hold each in a separate series so that if a lender forecloses on one property, the others are not affected. The tax section points out that there is no meaningful authority addressing whether a series of an LLC constitutes an entity for federal tax purposes that is separate and apart from the LLC and any other series of the limited LLC. Accordingly, members request that Treasury and the IRS issue guidance, similar to that provided by Notice 2008-19, on the entity classification of series LLCs.

Section members recommend an approach under which each series of an LLC is recognized as a separate business entity for purposes of reg. section 301.7701-2(a), assuming that specified minimum requirements are met. To be treated as a separate business entity, a series must be formed under an authorizing statute like the Delaware law and satisfy any applicable record-keeping and notice
requirements so that the liabilities of a particular series are only enforceable against the assets of that series.

The tax section further recommends that the characterization of the LLC itself for federal tax purposes should depend on whether the LLC satisfies the minimum requirements to be a business entity separate from its series. Members maintain the LLC has no separate existence and should be treated as transparent or as a nominee unless it has assets and liabilities that are not associated with one or more of its series. Members say that if it does have separate assets and satisfies applicable record-keeping and notice requirements so that the liabilities of the LLC may only be enforced against its own assets, the LLC should be characterized as a separate business entity.

The tax section asserts that the treatment of the LLC and each of its series as separate business entities would mean their classification for federal tax purposes is determined independently. Therefore, if an LLC or any one of its series has at least two members, that series or the LLC would be classified as a partnership unless it elects to be classified as an association taxable as a corporation under the regs. Alternatively, if a series or the LLC has a single member, the series or the LLC would be disregarded as an entity separate from its single member unless it elects to be classified as an association taxable as a corporation.

Acknowledging that its recommendations may conflict with the way some taxpayers are treating their series LLCs, the tax section proposes that the requested guidance generally be applied prospectively. Existing series LLCs would be allowed to rely on the guidance if they are formed under an authorizing state statute such as the one in Delaware, satisfy applicable record-keeping and notice requirements, and have been consistent in their treatment of the arrangement in accordance with the guidance.

Charitable Contributions

The American Council on Gift Annuities (ACGA) and the National Committee on Planned Giving (NCPG) in a December letter to House and Senate members requested that legislation be enacted to expand and make permanent laws that enable individuals to make tax-free charitable contributions from IRAs (Doc 2008-27305, 2008 TNT 251-13).

For 2006 through 2009, individuals who are 70½ or older can make direct gifts from an IRA, including their required minimum distributions, of up to $100,000 per year to public charities (other than donor-advised funds and supporting organizations) and to private operating foundations and passthrough foundations without having to report the IRA distributions as taxable income on their federal returns.

ACGA and NCPG contend that the Worker, Retiree and Employer Recovery Act of 2008, which waives the required minimum distribution rules for 2009, “has the unintended consequence of adversely affecting the people served by our nation’s charities.” While supporting the new law as beneficial during the current economic crisis, the organizations ask that some charitable contribution and IRA rollover rules be modified to prevent the unintended elimination or reduction of tax-encouraged charitable gifts from IRAs.

First, ACGA and NCPG advocate removing the $100,000 ceiling on direct IRA contributions to charity, or in the alternative, increasing the maximum.

Second, the groups recommend allowing IRAs to be rolled over tax free into life-income charitable gifts (such as charitable remainder annuity trusts, charitable gift annuities with immediate payments, and standard-payout charitable remainder unitrusts), that would provide retirement income for donors. The organizations claim the proposal would not cost the Treasury anything and might even have a positive revenue effect.

ACGA and NCPG say that permitting individuals age 59½ or older to make tax-free IRA rollovers to life-income charitable gifts would benefit the same qualified donees as direct rollovers do, while allowing donors to retain retirement income. Further, the groups believe their proposal will “generate additional tax revenue for the Treasury, but because income payouts from the life-income plans are higher than the required minimum distributions it will also stimulate the economy.”

Julie Brienza, Eben Halberstam, Andy Sheets, and Emily Vanderweide contributed to this column.
In-House Advertisement
Intentionally Removed
Strategies for Defending Against Discovery Requests for Tax Returns

By Nancy T. Bowen

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A. Background

As tax practitioners, we are often called on to handle tax disputes that are based almost entirely on complex provisions of the Internal Revenue Code or Treasury regulations. But we are also often called on to handle tax-related issues that arise out of nontax disputes. One tax-related issue that frequently occurs in nontax disputes is a discovery request to produce federal income tax returns. Consider the following scenario:

Your litigation partner calls you late one afternoon. “I have a deadline in a few days for responding to discovery requests in a case I am handling in federal court. The plaintiff has demanded we produce my client’s income tax returns for several years. My client is yelling bloody murder because he doesn’t want to produce his returns. I looked in Weinstein3 and didn’t see any discussion of any privilege to withhold tax returns, and another treatise4 flatly states there is no such privilege. Can you help me?”

You can help your partner, but the answer to his question will not be found where a tax lawyer might first look for it. Sections 6103 and 7213 prohibit the disclosure of tax returns and return information by government employees, but neither statute applies in litigation between private parties.3 Instead, federal courts have developed a common-law privilege to limit the discovery of tax returns in nontax civil litigation between private parties.4 Because the privilege is judge-made, it is not uniform and varies from jurisdiction to jurisdiction (and sometimes even within a given jurisdiction). As discussed in more detail below, the keys to defending against the discovery of tax returns are to determine precisely which versions of the privilege may apply in your jurisdiction, as well as the policy reasons given for recognizing the privilege, and then to tailor your arguments against the discovery of tax returns accordingly.

This article will first outline the scope of the privilege against the discovery of tax returns as that privilege has been adopted in various jurisdictions, as well as the differing policy reasons that have been given for adopting the privilege. This article will then suggest specific strategies and arguments to consider in defending against the discovery of tax returns.

B. The Scope of the Privilege

There are three primary permutations of the privilege. The earliest (and most straightforward) version of the privilege appears to be grounded in the theory of waiver. That version of the privilege generally prohibits the discovery of tax returns unless the party resisting discovery has effectively waived the privilege by raising an issue to which his tax returns would be relevant. For example, under the broadest version of this privilege, tax returns are not discoverable unless the “litigant himself tenders an issue as to the amount of his income.”5 Other courts have adopted this rule (the Kingsley rule) and have limited the discovery of tax returns to fact patterns in which the party resisting discovery has himself made an issue of his income.6

4The primary focus of this article is on the federal common-law privilege against the discovery of tax returns. If state law claims are in issue in federal court, then state (rather than federal) privilege law will control. See Fed. R. Evid. 501. (“In civil actions and proceedings, with respect to any element of a claim or defense as to which state law supplies the rule of decision, the privilege of a witness . . . shall be determined in accordance with state law.”) For an example of a case in which a federal court applied state privilege law regarding the discovery of tax returns, see Credit Life Ins. Co. v. Uniworld Ins. Co., 94 F.R.D. 113, 118-121 (S.D. Ohio 1982). The distinction between federal and state privilege law may not make a difference in many cases, as evidenced by the fact that any number of diversity cases have resolved discovery disputes involving tax returns without even mentioning state privilege law. See, e.g., Mitsui & Co. v. Puerto Rico Water Res. Auth., 79 F.R.D. 72, 80-82 (D.P.R. 1978).
Other courts have abandoned the waiver theory underlying the *Kingsley* rule and have allowed discovery of tax returns even when the party resisting discovery did not place his income in issue. For example, some courts routinely allow discovery of a defendant’s tax returns when punitive damages are in issue, reasoning that the tax returns are relevant to the calculation of punitive damages even though the defendant did not place his own income in issue. In *Payne v. Howard*, 75 F.R.D. 465, 470 and n.5 (D.D.C. 1977), the court recognized the general rule that tax returns are not discoverable unless the party resisting discovery (the defendant) makes an issue of his income, but noted that “defendant’s income may be in issue where punitive damages are sought.”17

Still other cases have recognized that tax returns may be relevant to issues other than a party’s income, and have further expanded the scope of permissible discovery. For example, in *Slater v. Yacht Outward Bound*, 71 F.R.D. 561 (N.D. Ill. 1976), the plaintiff sued to recover for her husband’s death while serving as a seaman on a yacht. The plaintiff hoped to make the yacht owner’s employer liable under the theory of respondeat superior, and sought discovery of the owner’s tax returns to determine the extent to which the owner had deducted his operating expenses for the yacht as business expenses. The court ordered the owner to produce his tax returns because they were relevant to the owner’s denial that he was using the yacht for business purposes, “even though his income is not directly in issue.” 71 F.R.D. at 564.18

Each of the permutations of the *Kingsley* rule outlined above focuses solely on whether tax returns may be relevant to an issue in the case. If the returns are sufficiently relevant, the inquiry is over and the returns are discoverable. Other courts, however, have adopted a test that balances the general interest in broad discovery under the Federal Rules of Civil Procedure against the policy interest in minimizing the disclosure of tax returns. This two-pronged test looks to the relevance (and often to the degree of relevance) of the tax returns only as the first step of the inquiry. If the returns are sufficiently relevant to an issue in the case, this two-pronged test then examines whether there is a compelling need for discovery of the returns because the relevant information contained in the returns is not readily available else-

where. This test was first expressed in *Cooper v. Hallgarten & Co.*, 34 F.R.D. 482, 484 (S.D.N.Y. 1964) as follows: “The production of tax returns should not be ordered unless it clearly appears they are relevant to the subject matter of the action or to the issues raised thereunder, and further, that there is a compelling need therefor because the information contained therein is not otherwise readily obtainable.” Many later cases have adopted the *Cooper* rule, although often with some slight variation.19

Finally, some courts have applied yet a third version of the privilege against discovery of tax returns. Those courts have concluded that discovery of tax returns should not be “routinely required,” but that returns should be discoverable in “appropriate circumstances” or when “clearly required in the interests of justice.” 20 On careful analysis, however, most of those cases involve some variant or combination of the *Kingsley* or *Cooper* rules outlined above. 21 Several cases have considered the *Cooper* and *Kingsley* rules to be alternatives, and have suggested that even if the two-pronged and *Cooper* rule is not satisfied, discovery will nevertheless be permitted if a party has placed his own income in issue.22

**C. The Policies Behind the Privilege**

Courts also differ widely in their explanations of the reasons for adopting a privilege against the discovery of tax returns. Some courts have pointed to the broad privacy concerns that are underscored by sections 6103 and 7213. See *Kingsley*, 20 F.R.D. at 158; and *Cooper*, 34 F.R.D. at 483. Other courts have cited the government’s interest in encouraging taxpayers to disclose all of their income, reasoning that taxpayers might be less willing to report all of their income if they face the prospect of their

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17 See *Gattegno v. PriceWaterhouseCoopers LLP*, 205 F.R.D. 70 (D. Conn. 2001) (gathering cases and discussing the development of the *Cooper* rule).
19 See, e.g., *Mitsui*, supra note 10, 79 F.R.D. at 80-81 (considering factors relevant to both the *Kingsley* rule and the *Cooper* rule); and *Teled-Tele*, supra note 10, 92 F.R.D. at 375 (considering both the *Kingsley* factor of whether the party resisting discovery had made its income an issue and the *Cooper* factor of whether the information sought was otherwise available).
20 See, e.g., *United States v. Bonanno Organized Crime Family*, 119 F.R.D. 625, 627 n.2 (E.D.N.Y. 1988); supra note 10, 92 F.R.D. at 375 (considering both the *Kingsley* factor of whether the party resisting discovery had made its income an issue and the *Cooper* factor of whether the information sought was otherwise available).
tax returns being discoverable in later civil litigation. See Fed. Sav. & Loan Ins. Corp. v. Krueger, 55 F.R.D. at 514. Still others cite the governmental interest in encouraging taxpayers to file complete and accurate returns in all respects, including the full disclosure of both income and of available losses or deductions. See Smith v. Bader, 83 F.R.D. 437, 438 (S.D.N.Y. 1979) (citing the governmental interest in having taxpayers file “complete and accurate returns”); and Payne v. Howard, 75 F.R.D. at 469 (limiting discovery of tax returns to encourage full reporting of income, as well as full usage of tax saving measures to which taxpayers are lawfully entitled). Other courts reason that discovery of returns should be limited because litigants should not be forced to disclose their tax returns as the price of bringing or defendinig litigation. See Tele-Radio, 92 F.R.D. at 375 (D.N.J. 1981).

D. Strategies for Defending Against Discovery

Once you determine the scope of the privilege against the discovery of tax returns in your jurisdiction, as well as the policy reasons given for the privilege, you can tailor your arguments accordingly. Several potential arguments are outlined below.

1. Strategies based on relevance.

a. Argue that the information contained in the return is not relevant. The first step in making an effective relevance objection is to consider the version of the privilege adopted in your jurisdiction. If the earliest version of the Kingsley rule is adopted, tax returns are relevant (and discoverable) only if the party resisting discovery has made an issue of his income. That means, for example, that the plaintiff’s tax return may be relevant if the plaintiff seeks lost wages or income. See Taylor v. Atchison, Topeka & Santa Fe Ry., 33 F.R.D. 283, 286 (W.D. Mo. 1962). On the other hand, the defendant’s tax returns would not be relevant even if punitive damages are sought. Many jurisdictions, however, have abandoned this very narrow reading of the Kingsley rule and have concluded that tax returns are subject to discovery if punitive damages are in issue, or if the returns otherwise may shed light on an issue in the case. See Payne v. Howard, 75 F.R.D. at 470 and n.5 (punitive damages); and Shaver v. Yacht Outward Bound, 71 F.R.D. at 564 (returns discoverable when they “may cast significant light” on an issue, even though income is not directly in issue).

You should also carefully examine the claim of relevance that is made by the party seeking discovery of a return. In some cases, the potential relevance of a return is apparent — for example, if a party seeks damages for lost wages or lost profits, tax returns that contain information about the amounts of past and present wages or profits would be relevant. In other cases, the information in a party’s tax return simply is not relevant to the matters sought to be proven. Examples are cases in which only compensatory damages (not punitive damages) are in issue, or cases in which the tax returns of corporate officers are sought, but the only defendant is the corporation.

There are other cases in which tax returns at first glance might appear relevant to an issue in a case, but in reality may not be. One example is a case in which punitive damages are sought from an individual, such that the individual’s net worth is in issue. See Van Westrienen v. Americontinental Collection Corp., 189 F.R.D. 440, 441 (D. Ore. 1999) (when punitive damages are in issue, an individual defendant’s financial ability to pay “is best measured in terms of his assets and liabilities as shown by a financial statement”). Unfortunately, courts have not always carefully considered precisely what tax returns will and will not reveal and have merely assumed that tax returns are relevant (for example) to prove a conspiracy, or to establish personal jurisdiction over a party, or to help prove alter ego allegations.

b. Argue for a higher standard of, or a more detailed showing of, relevance. Some courts require that a higher standard of relevance be met before they allow discovery of tax returns. See Gatto v. PricewaterhouseCoopers LLP, 205 F.R.D. at 73 (tax returns are discoverable when it “clearly appears” they are relevant); and In re Dayco Corp. Derivative Securities Litigation, 99 F.R.D. 616, 625 (S.D. Ohio 1983) (discovery of tax returns is appropriate if they are “significantly relevant” to an issue).

Other cases require a more detailed showing of relevance. For example, some cases have concluded that broad allegations of outrageous behavior in support of a claim for punitive damages are not sufficient to justify discovery of tax returns. Instead, these cases conclude that a complaint must allege facts that show a “real possibility” that punitive damages will be at issue.

As tax lawyers are aware, a Form 1040 individual income tax return reveals an individual’s income for a single year, but contains no balance sheet or financial statement such as that discussed in Van Westrienen. Unfortunately, the court did not mention that fact, but instead went on to suggest that at best, “plaintiffs are only entitled to a redacted personal income tax return produced pursuant to a protective order.” 189 F.R.D. at 441.

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14See Pettrey v. Enterprise Title Agency, Inc., 470 F. Supp. 2d 790, 794 (N.D. Ohio 2006) (assuming, without discussion, that tax returns are likely to reveal whether a conspiracy exists); Cottraum Commodity Trading Co. v. Seaboard Corp., 189 F.R.D. 685, 664-665 (D. Kan. 1999) (assuming, without discussion, that the defendant’s returns would be relevant to compare the relative level of sophistication of the parties); and Credit Life Ins. Co. v. Unibworld Ins. Co., 94 F.R.D. 113, 120-121 (S.D. Ohio 1982) (holding, without explanation, that returns are relevant to determining personal jurisdiction over defendants, as well as possibly supporting plaintiff’s alter ego theory).

interpret this policy interest, concluding that it would not prevent discovery of tax returns when the discovery is designed to obtain information about tax losses because it is in a taxpayer’s best interest to disclose those matters in all events. See Smith v. Bader, 83 F.R.D. at 439 (citing Houlihan v. Anderson-Stokes Inc., 78 F.R.D. 232, 234 (D.D.C. 1978)). In contrast, other courts have more broadly interpreted this policy basis for the privilege, concluding that it protects against discovery designed to obtain information about tax saving measures as well as taxable income. See Payne v. Havard, 75 F.R.D. at 469.

3. Strategies based on the absence of compelling need.

a. Argue that there is no compelling need for production of the return because the information sought is available elsewhere. The information contained in tax returns almost always is taken from some other document or source. That means the information sought to be obtained from the return generally will be available elsewhere. For example, if lost wages or loss of earnings is in issue, Forms W-2 or even stubs from paychecks can provide the necessary information.18

Likewise, there are often other sources for financial information.19 For example, nearly all of the financial information contained in a business’s tax return is taken from the business’s financial statements or its books and records and is readily available from those other sources.20

Even if the information is not directly available from a business’s financial books and records, there are frequently other sources for the information. For example, a plaintiff was not allowed discovery of the defendant dentist’s tax returns to show that the dentist had taken on a heavy workload, when the plaintiff could instead

36 State law may well influence a federal court’s ultimate decision concerning the discovery of tax returns when the court is sitting in diversity. Some federal courts have concluded that on this fact pattern, they are bound to follow the law of the forum state regarding bifurcation and may defer or delay the discovery of tax returns when punitive damages are sought. See, e.g., Davis v. Ross, 107 F.R.D. at 327-328. Other federal courts have ignored state law in this fact pattern, insisting that matters of procedure in federal court, such as discovery, are governed by federal law. See Mid-Continent Cabinetry, 130 F.R.D. at 151 and n.1 (criticizing Davis v. Ross, supra). Still other courts at least consider state law, but take a middle ground of bifurcating the issues of liability and damages, while allowing discovery of the defendant’s financial condition to go forward. See Hazelvine v. Beverage Media Ltd., et al., No. 94 Civ. 3466 (CSH), 1997 U.S. Dist. LEXIS 8971 (June 26, 1997).

obtain information about the dentist’s workload from his appointment book. *Payne v. Howard*, 75 F.R.D. at 470. Likewise, the court refused to order the production of the plaintiff’s tax returns when the defendant had already obtained information through discovery about the plaintiff’s financial motives to rescind a contract. See *Troglione v. McIntyre Aviation Inc.*, 60 F.R.D. 511 (W.D. Pa. 1973).

There are situations, however, in which the information sought from a tax return is not otherwise available. One example is that of self-reporting of tips or gratuities in addition to wages reported by an employer on Form W-2. See *Cooper*, 20 F.R.D. at 158. Another example is in determining whether an individual’s expenditure had been deducted as a business expense for tax purposes, which would indicate that the individual was acting within the scope of his employment.21

Courts are also more likely to allow discovery of tax returns if there is some indication that the books and records of a business may not be complete or if there are indications of fraud.22

b. Even if the information sought from a tax return is not otherwise readily available from a specific document or source, offer to provide the necessary information in another form. Courts have been particularly willing to forgo ordering the production of tax returns if the party resisting discovery offers to provide the information sought in a different form. Some examples are *Commodity Futures Trading Comm’n v. Collins*, 997 F.2d 1230, 1233-1234 (7th Cir. 1993) (refusing to compel the discovery of tax returns when the plaintiff could simply ask the defendant if he traded off the exchange); *Chenowith v. Scharf*, 98 F.R.D. at 590 (discovery of tax returns is not necessary when punitive damages are at issue; general statement of net worth would be sufficient); and *Rubenstein v. Kleven*, 21 F.R.D. 183, 185 (D. Mass. 1957) (plaintiff sued to enforce an alleged agreement to pay her $1,000 per month for life; if plaintiff will admit that nothing in her tax returns reflected any of the payments she claimed to have received in the past, then production of her tax returns will not be ordered). There are obviously limits, however, to the alternative forms of disclosure that courts are willing to accept. For example, in *Shaver v. Yacht Outward Bound*, 71 F.R.D. at 564, the court refused to allow a party resisting discovery to examine his own returns and then to swear by affidavit about what those returns contain.

4. Strategies to limit the scope of discovery or the further dissemination of tax return information.

a. Attempt to limit the amount of information from the return that is produced. Even if a tax return contains relevant information and even if that relevant information is not available elsewhere, a return also contains a great deal of extraneous information that should not be disclosed. Courts have been receptive to the argument that parties should be required to produce only the relevant portions of a return, rather than the entire return.23

In addition to limiting discovery only to relevant portions of tax returns, you should also argue that discovery should be limited only to returns for relevant tax years. For example, in *Biedler v. Hurst*, Civil Action No. 20185, 1957 U.S. Dist. LEXIS 4671 (E.D. Pa. May 27, 1957), the plaintiff alleged that the defendant had induced him to enter into a partnership through false representations. The court allowed discovery of the defendant’s tax return for the year in which the partnership was formed, reasoning that the return might throw light on the financial condition of the business at that time. The court also ruled, however, that the defendant’s returns for later years were not relevant. Id.24

The opposing party, of course, may be reluctant for you or your client to make the final determination of whether undisclosed portions of the returns are in fact relevant. In that case, a possible compromise is to produce any admittedly relevant portions of the returns, and then to allow opposing counsel or the court to review the unredacted returns to confirm they contain no additional relevant information. For example, in *Hill v. SFC Inc.*, 170 F.R.D. 182 (D. Kan. 1997), the plaintiff produced a redacted copy of her tax return and Forms 1099-G and W-2, while defense counsel was allowed to review the unredacted returns (subject to a confidentiality order) to confirm the information reflected in the disclosed forms. For another example, some courts have inspected the disputed returns in camera to confirm whether they were accurate within the scope of their employment.21

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21See, e.g., *Shaver v. Yacht Outward Bound*, 71 F.R.D. at 564 (recognizing that defendant’s tax returns may be the only available source of this information).

22See *Securities and Exchange Comm’n v. Cymaticolor Corp.*, 106 F.R.D. at 548 (trading records may not reflect all trades in a particular stock because trades could have been made through accounts in foreign countries or in the names of third parties); and *Cooper*, supra note 8, 34 F.R.D. at 485 (if on examination, it appears that the plaintiff’s financial records are inaccurate then the defendants may reapply for the production of tax returns). Other courts, however, will order the production of tax returns, even if the party seeking discovery wants those tax returns only to confirm information it already has. See *Court DeGrave Theatre Inc. v. Locow’s Inc.*, 20 F.R.D. 85, 86 (E.D.N.Y. 1957) (discovery of plaintiff’s tax returns ordered so that defendant can determine the accuracy of the figures it had previously obtained from the plaintiff’s books and records).

23See, e.g., *Hill v. SFC Inc.*, 170 F.R.D. 182 (D. Kan. 1997) (in which plaintiff’s earnings were in issue, and defendant was entitled to discovery of relevant portions of return); *Stark v. Photo Researchers Inc.*, 77 F.R.D. 18 (S.D.N.Y. 1977) (in action for damages incurred by defendant photo broker’s failure to return slides; defendant was entitled to discovery of those portions of plaintiff’s income tax return relating to income derived from photographic endeavors); and *Taylor v. Atchison, Topeka & Santa Fe Ry.*, 33 F.R.D. 283 (W.D. Mo. 1962) (in action for loss of wages and earnings, court ordered the production of portions of plaintiff’s return relating to wages and earnings).

24See also *Taylor v. Atchison Topeka & Santa Fe Ry.*, 33 F.R.D. at 286 (in action for loss of wages and earnings, discovery of pertinent portions of income tax returns allowed for “a reasonable period before and after the alleged injury”).
contained relevant information. Courts have been particularly receptive to this argument in the case of joint tax returns, when only one spouse’s income is in issue in the litigation.25

b. Seek to limit further disseminations of the return or the information in the return. Even if returns or portions of returns are to be produced, alternatives still exist to limit the public dissemination of return information. One alternative is to request that the return information be subject to an “attorneys’ eyes only” order.26 Alternatively, you can argue that the return should be subject to a protective order and/or sealing order.27

E. Conclusion

Tax returns contain a great deal of sensitive information that taxpayers are understandably reluctant to disclose, including Social Security numbers, names of dependents, and sources and amounts of income. Recognizing this fact, federal courts have developed a privilege against the discovery of tax returns. The scope of the privilege, as well as the policy reasons for the privilege, vary widely from jurisdiction to jurisdiction, and even within a given jurisdiction. Practitioners should tailor their arguments accordingly to prevent or limit either the discovery or the further dissemination of their client’s tax returns.

Congress: How About a Mulligan For the Accelerated Election?

By William A. Raabe, Cherie J. Hennig, and John O. Everett

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Stop! Please close that Word file titled “Huh, Oh, We Need More Tax Stimulus Before We Get Too Far Into 2009 Act,” back slowly away from the computer and that copy of the Internal Revenue Code, and no one will get hurt.

Admit it. Isn’t this the message you would like to send to the tax policy proletariat in Washington? Remember when tax legislation was enacted only once every few years, rather than every fourth Thursday of the month? In 2008 alone, tax professionals had to deal with the following major pieces of legislation that contained tax provisions.

• the Economic Stimulus Act of 2008;
• the Food, Conservation, and Energy Act of 2008;
• the Housing and Economic Recovery Act of 2008; and

Other 2008 legislation with tax provisions included:

• the Consolidated Appropriations Act for FY2008;
• the Airport and Airway Extension Act of 2008;
• the Genetic Information Nondiscrimination Act of 2008;
• the Heroes Earnings Assistance and Relief Tax Act of 2008;
• the Federal Aviation Administration Extension Act of 2008;
• the Hubbard Act;
• the SSI Extension for Elderly and Disabled Refugees Act;
• the Federal Aviation Administration Extension Act of 2008, Part II;
• the Continuing Appropriations Resolution, 2009, Division A;
• the LU Technical Corrections Act of 2008;
• legislation to restore the Highway Trust Fund balance;
• the Court Security Improvement Act of 2007;
• the Fostering Connections to Success and Increasing Adoptions Act of 2008;
• Michelle’s Law;
• the Inmate Tax Fraud Prevention Act of 2008;
• the Unemployment Compensation Extension Act of 2008; and
• the Huh, Oh, We Need More Tax Stimulus Before We Get Too Far Into 2009 Act (awaiting passage).
Granted, there are compelling reasons for much of this legislation, as a volatile economy remains to dominate everyone's lives. But no matter how well-intentioned, this rushed legislation is often vague, confusing, and sometimes contradictory. Even worse, the planning window for many of those provisions is frequently quite short because Congress may believe that instant gratification is the only way taxpayers will respond to a tax stimulus provision in a timely fashion.

One of the stimulus provisions in the Housing Assistance Tax Act of 2008 (part of the larger Housing and Economic Recovery Tax Act of 2008) was the addition of section 168(k)(4). That provision allows a rare opportunity for corporate taxpayers: the ability to cash in unused research and alternative minimum tax credit carryovers, at the cost of surrendering bonus depreciation on specified properties placed in service in 2008. The credits used under this election are refundable, an unusual trait in corporate tax law, allowing taxpayers to monetize credit carryforwards that were thought otherwise to be deferred for years or simply lost forever. However, a combination of unanswered questions, unintended consequences, and a much-too-short time frame for election all have made this provision the poster child for the do-over for the election in 2009 after some fixes are made.

We briefly review how the section 168(k)(4) election works and raise 10 questions regarding defects in the legislation, and argue that Congress must provide a do-over for many of those provisions is frequently quite short because Congress may believe that instant gratification is the only way taxpayers will respond to a tax stimulus provision in a timely fashion.

We examine the unanswered questions and unintended consequences of the election, suggest changes in the legislation, and argue that Congress must provide a do-over for the election in 2009 after some fixes are made. We briefly review how the section 168(k)(4) election works and raise 10 questions regarding defects in the legislation. We conclude that the statute should be extended for at least one year so that more corporate taxpayers will have the time and motivation to evaluate the election properly and make an informed decision about how to best use those tax incentives.

A. The Section 168(k)(4) Election: The Basics

The section 168(k)(4) election is relatively simple. A corporate taxpayer may surrender bonus depreciation (and must use straight-line recovery) on all eligible qualified property placed in service after March 31, 2008, and before January 1, 2009 (some limited exceptions are noted below). By agreeing to the election, the taxpayer converts some of its pre-2006 research credit and AMT credit carryovers into instantly refundable tax dollars. Technically, the converted amount (called the bonus depreciation amount in the statute) triggers modifications to the business tax credit annual limitation in the case of research credits, and to the excess of regular tax over tentative minimum tax annual limitation for AMT credits. The taxpayer chooses how to allocate the bonus depreciation amount between the two credits.

The bonus depreciation amount is 20 percent of the difference between (1) the aggregate depreciation allowed on the eligible qualified property if bonus depreciation is claimed and (2) the aggregate depreciation allowed if no bonus depreciation is claimed. However, the bonus depreciation amount is subject to a maximum increase amount, the lesser of (1) $30 million or (2) 6 percent of pre-2006 unused business and AMT credits. This calculation can be illustrated when only one item of personally qualifying for bonus depreciation was placed in service during the last nine months of 2008.

Example: Stimulus Corp., a calendar-year corporation, has $10 million in unused research credits and $15 million in unused AMT credits as of the beginning of 2008. During the last nine months of 2008, Stimulus placed in service $14 million of eligible qualified property in the seven-year modified accelerated cost recovery system category (a single asset placed in service on July 1, 2008). The bonus depreciation amount is computed as $1,199,940.

| Depreciation with bonus depreciation | $8,000,300 |
| Depreciation without bonus depreciation | $7,800,300 |
| Difference | $200,000 |

Bonus depreciation amount
Maximum increase amount - least of:
(a) Computed bonus depreciation amount; $1,199,940
(b) $30,000,000 maximum; or $30,000,000
(c) 6 percent of unused research and AMT credits ($25,000,000 x .06); $1,500,000

The bonus depreciation amount of $1,199,940 is less than the 6 percent and $30 million limits, so the taxpayer's unused research and AMT credits now are instantly refundable to this extent (allocable between the two credits in a manner chosen by the taxpayer).

The cost of making this election is that Stimulus must forgo bonus depreciation on the $14 million acquisition of personality and must use straight-line recovery over the MACRS life of the asset. Thus, the first-year cost recovery deduction would be $1 million ($14 million cost/seven-year life * .50 half-year convention), rather than $8,000,300.

B. Planning for the Section 168(k)(4) Election

Credits and deductions are more valuable in earlier tax years because of the time value of money. The tax benefit of the deduction or credit is a function of the taxpayer's after-tax rate of return. Tax planning strategies usually involve an acceleration of the taxpayer's deduction and credit items that may expire before they can be used. The section 168(k)(4) election, which allows for a

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1Section 168(k) allows a 50 percent bonus depreciation deduction for qualifying modified accelerated cost recovery system property placed in service during 2008.
2Section 168(k)(4)(C)(i).
3Section 168(k)(4)(C)(ii).
4If a tax benefit is realized today, it has a present value factor of 1.0, but if the item cannot be used for five years and the taxpayer's after-tax rate of return is 6 percent, the present value factor falls to 0.7473. Thus, the item loses more than 25 percent of its value to the taxpayer due to the deferral.
for such an acceleration, is most attractive to a corporation that operates in a generally constant net operating loss environment. A current-year cash infusion is more attractive than wishing and hoping that profitability will return so that unused credits will shelter future profits from income taxation. Similarly, the election is attractive to a corporation that is in a generally constant AMT environment. While AMT credit carryforwards do not expire, they are unlikely to be used in the near future, making them worth less in a time value of money context.5

Profitable corporations should also consider the election. The ability to monetize credit carryforwards at the taxpayer’s current marginal tax rate may be attractive. Those taxpayers will devise a breakeven point in trading off the accelerated credits against the slower cost recovery deductions that result from forfeiting the bonus depreciation amounts.

An evaluation of the section 168(k)(4) accelerated credit election must consider the following interrelated factors:

• possible loss of bonus depreciation that is not compensated for with additional credit accelerations due to the 6 percent limitation;
• time value of money concepts to account for differing cost recovery and credit schedules;
• possible alternative use of the credits without the acceleration election;
• orchestrating asset acquisitions late in 2008;
• possible additional 2009 acquisitions under the extended placed-in-service rules for some properties that maximize the acceleration of credits;6 and
• allocations of the credits between the research and AMT carryforward amounts.

C. Ten Reasons for a Mulligan on the Election

While the above example illustrates the tax trade-offs involved in making a section 168(k)(4) election, other factors complicate the decision-making process, and there is little guidance to help the taxpayer. Our top 10 questions highlight those factors and build a case for a do-over of the statute, including an extension of time for making the election.

1. What’s the underlying policy motivation? The section 168(k)(4) election comes on the heels of a provision in the Economic Stimulus Act of 2008 reinitstituting the bonus depreciation rules that have been dormant since 2005. In February 2008, taxpayers were encouraged to invest in more personality to receive this bonus deduction. Companies that responded in the first three months of 2008 were chagrined later to learn that those acquisitions did not qualify for the bonus depreciation amount that could be monetized through a refund of unused tax credits that was part of the Housing and Economic Recovery Act of 2008 passed on July 30. By then, many corporate capital budgets for 2008 had been spent and there was little maneuverability to take advantage of the election.

In early February 2008, Congress enacted a powerful incentive to make capital investments immediately and then in July offered another powerful incentive to give up the previous incentive of bonus depreciation for some cash, which as a motivating device always is attractive. How can a company plan when to make capital acquisitions in this environment? With the one-year window for bonus depreciation, and the nine-month window for the acceleration election, it appears that Congress ended up offering a cash windfall to corporations that delayed their equipment purchases to the last half of 2008 rather than trying to exhibit a steady influence on capital investment behavior.

2. How can a simple decision become so complicated so quickly? The conventional wisdom of Congress seems to be that a section 168(k)(4) election will be made by corporations with either unused losses or unused AMT credit carryforwards. But the accelerated credits election may make sense for profitable corporations as well. In this regard, a corporation must consider several factors in the election decision. These include estimates of amounts and patterns of credit utilization that would otherwise occur if the acceleration election were not made, as well as time value of money considerations for differing cost recoveries. A profitable entity might find that an advantage to making the election is an increase in the present value of its after-tax cash flow. An Excel spreadsheet evaluating the election for profitable entities is available from the authors.7

The accelerated credit decision can be complicated by factors that may easily be overlooked. For example, how does the election affect financial accounting reports? (A valuation allowance related to a deferred tax asset that must be reversed if the election is made will affect book income.) What about state income tax accruals in those states that have not adopted bonus depreciation or otherwise will not recognize the election, even though they may piggyback the federal law for their starting point of taxable income? And what about obtaining IRS consent for a change in a tax accounting method when the accelerated credit election is changed?

In short, this seemingly simple decision can become complicated very quickly. For cash-strapped businesses that see the opportunity to resurrect supposedly dead credits, providing only a few months to alter major capital investment decisions and consider all of the tax and nontax ramifications of the election is unrealistic.

3. Where’s the guidance? The Housing Assistance Tax Act was not signed by President Bush until July 30, 2008. The first general guidance on the accelerated credit election (and the only guidance as of December 2008) was

5A minimum tax credit is generated when the taxpayer is subject to the AMT. But the credit then is used only to reduce the tax liability when the regular tax computation, and not the AMT regime, applies.
6Property eligible for the election in 2009 includes an item that (1) is subject to the section 263A uniform capitalization rules; (2) has a production period greater than one year and a cost exceeding $1 million; or (3) has a MACRS recovery period of at least 10 years or is used in the trade or business of transporting persons or property for hire, such as commercial aircraft.

7Please contact the authors at jeverett@vcu.edu.
not issued until October, when Rev. Proc. 2008-65 was released. This document leaves many questions unanswered and provides general guidance only on allocating the credits and clarifying the effect of opting out of bonus depreciation on some properties.

The language in Rev. Proc. 2008-65 seems to indicate that the Service is throwing up its hands and saying it cannot respond with adequate guidance in a timely manner. The document pledges that “the IRS and Treasury intend to publish separate guidance on the time and manner of making the election.” But by then, the period in which the election must be made will have expired.

4. When is ‘eligible property’ eligible? What property is eligible for a section 168(k)(4) election? The statute can be read in several ways so that the “credit acceleration and straight-line only” provision applies to a calendar-year taxpayer for:

- all bonus depreciation property placed in service in 2008;
- all bonus depreciation property placed in service after March 31, 2008; and
- only the portion of acquisitions that is necessary to maximize the credit acceleration (for example, because the 6 percent limit kicks in).

It seems punitive to disallow the accelerated depreciation amounts for assets if the credit acceleration was not available due to some other constraint, but the code language does not rule out this interpretation. A more generous interpretation would allow the taxpayer to select, asset-by-asset or class-by-class, eligible property for the purpose of the section 168(k)(4) election, and then allow other acquisitions to qualify for bonus depreciation without constraint. For instance, if asset acquisitions are so large as to overfund the credit acceleration election, why not allow the bonus depreciation for the excess amount? Ideally, the taxpayer would drop assets into one of several categories:

- assets not eligible for credit acceleration (acquired before April 2008);
- assets eligible for credit acceleration and elected for this purpose; and
- assets eligible for credit acceleration but the election is not claimed, so that bonus depreciation still is allowed.

Rev. Proc. 2008-65 seems to imply that the third category above does not exist; that is, all property placed in service after April 2008 is “credit acceleration and straight-line only” if the election is made, even if the credits are not available relative to all of the assets due to one of the computational limitations.

5. How does section 179 mesh with the election? A corporation placing in service personally with a cost of less than $1,050,000 during the 2008 tax year will find itself in a quandary. Those acquisitions qualify for the section 179 immediate expensing option. How does section 179 affect the computation of the bonus depreciation amount? And would the deduction be allowed even if the taxpayer makes the acceleration election, with any amount not expensed subject to straight-line recovery? The statute appears to offer contradictory incentives in this case. The section 179 election is made first, and the amount of bonus depreciation amount seems to be computed after the section 179 amount is claimed. This raises the question of whether the bonus depreciation amount is computed only “after section 179,” or must straight-line cost recovery be used on all of the year’s acquisitions if the election is made?

6. What about the mid-quarter rule? Rev. Proc. 2008-65 refers to the MACRS mid-quarter convention, so the mid-quarter rules continue to apply in computing the bonus depreciation amount, even though section 168(k) is silent about how the election interacts with the mid-quarter test. Thus, it is not clear whether pre-April 2008 acquisitions are used in applying the 40 percent test for the mid-quarter convention.

Look at what happens, however, using the facts of our earlier example, when the mid-quarter convention is in play. Assume that all of the acquisitions took place in the fourth quarter of 2008, a result that might not be unexpected for a taxpayer that has learned about the accelerated credit election and is attempting to maximize its tax savings.

<table>
<thead>
<tr>
<th>Depreciation with bonus depreciation</th>
<th>$7,249,900</th>
</tr>
</thead>
<tbody>
<tr>
<td>$[7,000,000 + ($7,000,000 x .0357)]</td>
<td></td>
</tr>
<tr>
<td>Depreciation without bonus depreciation</td>
<td>($499,800)</td>
</tr>
<tr>
<td>$[14,000,000 x .0357]</td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>$6,750,100</td>
</tr>
<tr>
<td>x .20</td>
<td></td>
</tr>
<tr>
<td>Bonus depreciation amount</td>
<td>$1,350,020</td>
</tr>
</tbody>
</table>

The mid-quarter convention is designed to penalize the taxpayer for excessive late-year asset acquisitions, by slowing down current-year cost recovery deductions. But in this context, the mid-quarter convention increases Stimulus Corp.’s bonus depreciation amount by more than 10 percent. Similar (although slightly smaller) increases in the bonus depreciation amount occur when the mid-quarter convention kicks in due to second- and third-quarter acquisitions. So does the new law now encourage or discourage the bunching of acquisitions at the end of the tax year?

7. What about credits that expired after 2005? Some research tax credits of corporations may have expired after 2005. Why are they not available to the taxpayer as increases to the business credit increase amount? If the tax policy objective is to monetize available credits that the taxpayer cannot cash in, those amounts should be available for the section 168(k)(4) election. Will the taxpayer have available the records by which to reanimate these credits? How would those credits be treated under IRS audit?

8. Why use the copy command for definitions? The subset of 2009 asset acquisitions that can qualify for the

---


9$250,000 maximum, reduced dollar-for-dollar for personality exceeding $800,000 placed in service during the year.

10Section 168(k)(4)(d).
credit acceleration (discussed at footnote 6) seems to be the same as under the pre-2005 bonus depreciation rules. This exception is welcome, in that it allows for some forward acquisition planning by the taxpayer, but a list of transactions and industries that is more responsive to current economic conditions would be better. For instance, the airlines probably still need to be on this list, but how about an incentive for the automotive industry or for aspects of infrastructure projects?

9. What is the reduction for prior bonus amounts?
   Another copy-and-paste problem arises in Rev. Proc. 2008-65 concerning a reduction of the bonus depreciation amount by the sum of bonus depreciation amounts that are computed for prior tax years. This process echoes the earlier reduction of the 2005 50 percent bonus depreciation amounts for those claimed at 30 percent for a prior tax year. Given that the 2008 computation relates to the first (and only scheduled) tax year for the availability of the credit acceleration, and that the statute does not address the issue directly, this provision does not appear to be needed. A generous interpretation of the language would relate the rule to “no double counting of acquisitions” for fiscal year taxpayers. But mainly this restriction confuses the issue.

10. Why the computational bias by MACRS asset class?
   There is a computational bias in deriving the taxpayer’s optimal amount of credit acceleration, relative to the trade-off of the loss of bonus depreciation deductions. In a time value of money sense, the largest tax savings are generated by investing in five-year MACRS property, and the tax benefits from other asset classes for a given dollar of investment are reduced by larger amounts as the asset class of the acquisition asset becomes larger.

   For example, consider the following present-value results if $5 million were invested separately in each of six MACRS classes of property (and that class only), assuming that $10 million of pre-2006 credits are present (that is, the 6 percent limit does not come into play).

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Projected Tax Cost (Savings) of Election</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-year MACRS</td>
<td>($186,691)</td>
</tr>
<tr>
<td>5-year MACRS</td>
<td>($333,400)</td>
</tr>
<tr>
<td>7-year MACRS</td>
<td>($197,786)</td>
</tr>
<tr>
<td>10-year MACRS</td>
<td>($165,624)</td>
</tr>
<tr>
<td>15-year MACRS</td>
<td>($143,202)</td>
</tr>
<tr>
<td>20-year MACRS</td>
<td>($89,756)</td>
</tr>
</tbody>
</table>

   Those distortions could be eliminated and the computation of the credits available for acceleration would be simplified, if the bonus depreciation amount were set at a fixed percentage, say 10 percent, of the total cost of the acquired property. To please tax historians, three-year property might be allowed bonus depreciation of 6 percent of the total cost.

D. Conclusion

   Through the creative use of tax attributes, Congress has offered the corporate taxpayer a valuable source of immediate cash, not an easy task in today’s political environment, without threatening the integrity of the tax system. The elective nature of the stimulus provision allows the taxpayer to consider short- and intermediate-term tax planning goals, while limiting the taxpayer’s ability to game the system. However, Congress did not take into account the considerable time and thought required by the typical corporation’s budgeting and tax departments to make a decision concerning a nuanced tax election like this one.

   Because asset acquisitions are usually planned at least a year into the future, the nine-month window doesn’t provide enough time to use this provision optimally. Moreover, the legislative history makes it seem that Congress believed the election would be attractive only to current-loss corporations. Rather, a trade-off of accelerated depreciation deductions for current credits also should be considered by profitable entities, a scenario that Congress apparently did not consider.

   The economic difficulties that this provision attempts to alleviate are global in nature and will not be solved in the short term. So why the rush to close the window of availability for the section 168(k)(4) election by January 5, 2009? The accelerated credit election may be a good idea for the economy, and may have a positive effect on several corporate taxpayers in need of a cash infusion through the tax incentives offered. However, corporations should be allowed to consider the provision in detail and adjust asset acquisitions appropriately to ensure that the election is used responsibly. And Treasury should be allowed time to issue reasonable and thorough guidance to explain how to comply with the requirements for the election.

   But more time is needed for this to happen. Good tax policy often includes an elective provision with specific targeted taxpayer behavior and a limited time frame for action, with a sunset of the provision. The general placed-in-service dates should be extended at least through 2009 so that corporate capital budgeting decisions can be in sync with the tax incentives that Congress has offered. It is encouraging that such an extension is included in the Obama version of the proposed 2009 stimulus bill. Economic recovery in the capital-intensive sector likely will be stabilized and accelerated by expanding the time in which this important election can be made.
Fifteen Years of Antichurning: It's Time to Make Butter

By Romina Weiss

Romina Weiss is a tax partner in the New York office of Gibson, Dunn & Crutcher LLP.

Section 197 was enacted to reduce controversy between taxpayers and the IRS in connection with the amortization of certain intangible assets, including goodwill and going concern value. Although section 197 has largely served its purpose, the antichurning rules contained in section 197(f)(9) remain a source of much consternation for tax practitioners. The author argues that the antichurning rules have outlived their usefulness, and that to promote fairness and efficiency, the antichurning rules should be repealed. A previous version of this report was presented by the author to the members of the Tax Club in New York.

The author would like to thank Greg S. Walker of Gibson, Dunn & Crutcher LLP, Dallas, for his invaluable assistance in drafting this article, and Jeffrey M. Trinklein of Gibson, Dunn & Crutcher LLP, New York, for his insightful comments. Any errors are solely those of the author.

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I. Introduction

The intangible assets of a business, such as goodwill, going concern value, patents, and customer lists, often constitute a significant portion, if not most, of the value of an enterprise, as compared with its tangible assets such as property, plant, and equipment. When a purchaser acquires the assets of a business, the purchaser’s ability to offset future taxable income generated by the business with depreciation or amortization deductions for U.S. federal income tax purposes can significantly affect the economics of the transaction; in other words, it can affect the price the purchaser is willing to pay for the business.

Before the enactment of the Revenue Reconciliation Act of 1993 (the RRA), 1 which added section 197, goodwill and going concern value were generally treated as nonamortizable intangible assets. 2 As a result, the portion of the purchase price of a business allocated to those assets could be used only to offset gain recognized on a future sale of the assets of the business.

Because of the less-than-optimal tax treatment of those intangibles, purchasers of businesses were often tempted to assign a proportionately greater amount of the purchase price of a business to depreciable tangible and amortizable intangible assets than to goodwill or going concern value. This often gave rise to conflicts between taxpayers, who attempted to allocate significant value to short-lived intangible assets similar to goodwill for which a useful life had been assigned and, accordingly, could be amortized, and the IRS, which claimed that a greater portion of the value should have been allocated to nonamortizable intangibles, such as going concern value. 3 The frequent litigation between taxpayers and the IRS, as amplified by the subjective nature of the valuation process generally and the significant amount of money at stake, was called one of the oldest controversies between taxpayers and the IRS by the General Accounting Office in its 1991 report to Congress on the taxation of intangibles. 4 Also, because depreciation deductions were allowed for the cost or other basis of intangible property used in a trade or business or held for the production of income only if the intangible property had a limited useful life that could be determined with reasonable accuracy, 5 questions about what constituted a limited useful life and reasonable accuracy abounded.

1 The RRA was enacted as part of the Omnibus Budget Reconciliation Act of 1993.


3 It also resulted in protracted negotiations between purchasers of businesses, who wanted to allocate as large a portion of the purchase price of a business as reasonably possible to a seller covenant not to compete, which portion could be amortized over the term of the covenant, and sellers, who wanted to allocate as small a portion of the purchase price of a business to the covenant, because the portion of the purchase price allocable to a covenant not to compete was treated as ordinary income rather than capital gain.


5 Reg. section 1.167(a)-3, before amendment by T.D. 8865.
Legislation similar to that eventually enacted was first proposed on July 25, 1991, with the GAO report following shortly thereafter. In 1992 the Supreme Court granted certiorari in Newark Morning Ledger Co. v. United States, a case involving some of the relevant issues, and it issued its decision on April 20, 1993. The taxpayer, Newark Morning Ledger Co. (as successor to the Herald Co.), was a newspaper publisher that had acquired eight newspapers and continued to publish them under their existing names. The taxpayer allocated $67.8 million of the purchase price, an amount equal to the publisher’s estimate of future profits to be derived from some identified subscribers (more than 450,000) to the eight newspapers as of the date of the merger, to an intangible asset it called “paid subscribers.” The subscribers’ contracts were terminable at will by the subscribers and did not require advance subscription payments. The taxpayer claimed depreciation deductions for the paid subscribers on a straight-line basis over the estimated useful lives for average at-will subscribers of different types (which had been calculated using actuarial tables and various other statistical factors), and the IRS challenged those deductions.

In the litigation that ensued, the government argued that the asset “paid subscribers” was indistinguishable from goodwill, which was specifically prohibited from being depreciated by Treasury regulation section 1.167(a)-3, as in effect at the time. However, the government stipulated to the taxpayer’s estimates of the useful life of the asset and did not contest the techniques used to calculate the taxpayer’s estimate of the total value of the asset.

A divided Supreme Court held 5 to 4 that if a taxpayer is able to prove with reasonable accuracy that an intangible asset that the taxpayer uses in a trade or business holds for the production of income has a value that wastes over an ascertainable period of time, the taxpayer may depreciate the value of the asset over the asset’s useful life regardless of how much the asset appears to reflect the expectancy of continued patronage. The Supreme Court cautioned that the taxpayer’s burden of proof was substantial and would often prove too great to bear. In this case, that the government had stipulated to the taxpayer’s estimates and calculations seemed to play an important role in the decision.

In response, Congress enacted section 197, in part because the “severe backlog of cases in audit and litigation” was “a matter of great concern.” Tax practitioners generally greeted the new section 197 with enthusiasm. What practitioners may not have realized was that 15 years after enactment, they would still be spending significant time and energy grappling with the antitrust provisions in section 197(f)(9) (the antichurning rules), which were intended to prevent taxpayers from converting a nonamortizable intangible into an amortizable section 197 intangible. Experience seems to have proven section 197 to have been a success in reducing controversies between taxpayers and the IRS in this area. The author believes, however, that because the antichurning rules are complex, appear now to be unfair, result in transactions with almost identical economics having different tax consequences, and cause taxpayers to restructure their nontax-motivated business transactions to avoid the rules, the time has come for the repeal of the antichurning rules in section 197(f)(9).

II. Statutory and Regulatory Overview

Although section 197 was enacted in 1993, proposed regulations were not issued until early 1997 and were not finalized until January 2000. Also, the final regulations issued in January 2000 included proposed regulations that elaborated on specific issues related to partnerships, and those proposed regulations were finalized in November 2000. Since then, there has been no significant guidance from the IRS or Treasury on these issues.

A. Section 197 Generally

Section 197 permits taxpayers to amortize the adjusted basis of those intangible assets that constitute amortizable section 197 intangibles ratably over 15 years, beginning with the month in which they are acquired. Section 197 intangibles comprise the following: (1) goodwill; (2) going concern value; (3) workforce in place, including its composition and terms and conditions of its employment.

8. Section 197(a).
employment; (4) business books and records, operating systems, or any other information base (including lists or other information regarding current or prospective customers); (5) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item; (6) any customer-based intangible, meaning composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers, and, in the case of a financial institution, deposit base and similar items; (7) any supplier-based intangible, meaning any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer; (8) any item similar to those listed in (3) through (7) above; (9) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (10) any covenant not to compete (or other arrangement to the extent it has substantially the same effect) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof; and (11) any franchise, trademark, or trade name.22

Intangibles specifically excluded from the definition of section 197 intangibles are: (1) any interest in a corporation, partnership, trust, or estate, or under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract; (2) any interest in land; (3) any computer software that is readily available for purchase by the public, is subject to a nonexclusive license, and has not been substantially modified, and other computer software that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof; (4) any of the following items if not acquired in a transaction or series of related transactions involving the acquisition of assets constituting a trade or business or a substantial portion thereof: (a) any interest in a film, sound recording, videotape, book, or similar property; (b) any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof; (c) any interest in a patent or copyright; and (d) to the extent provided in reg. section 1.197-2(c)(13), any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if the right has a fixed duration of less than 15 years or is fixed as to amount and would otherwise be recoverable under a method similar to the unit-of-production method; (5) any interest under an existing lease or tangible property or any existing indebtedness (except as provided regarding financial institutions); (6) any right to service indebtedness that is secured by residential real property unless the right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than those rights) constituting a trade or business or substantial portion thereof; and (7) any fees for professional services and any other transaction costs incurred by parties to a transaction regarding which any portion of the gain or loss is not recognized under sections 351 through 368.23

To constitute an amortizable section 197 intangible, a section 197 intangible must have been acquired after August 10, 1993, the date of enactment of section 197, and must be held in connection with the conduct of a trade or business or an activity engaged in for the production of income.24 Intangibles, other than (1) franchises, trademarks, or trade names; (2) covenants not to compete entered into in connection with an acquisition of an interest in a trade or business or a substantial portion thereof; and (3) licenses, permits, or other rights granted by a governmental unit or an agency or instrumentality thereof that are self-created rather than acquired will not constitute amortizable section 197 intangibles unless they are created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or a substantial portion thereof.25

If an asset constitutes an amortizable section 197 intangible, no other depreciation or amortization deduction is allowed with respect to it.26 Thus, if a covenant not to compete constitutes an amortizable section 197 intangible, a taxpayer must amortize any portion of the purchase price of a business allocated to the covenant over 15 years even if, under prior law, that amount would have been amortizable over the term of the covenant.27

Section 197(f) contains special rules that affect the applicability and operation of section 197. Among them is a rule that provides that if a section 197 intangible is acquired in a nonrecognition transaction under section 332 (complete liquidations of subsidiaries), section 351 (transfers to controlled corporations), section 361 (nonrecognition of gain or loss to corporations), section 721 (contributions to partnerships), section 731 (distributions from partnerships), section 1031 (like-kind exchanges), section 1033 (involuntary conversions), or in a transaction between members of an affiliated group that files a consolidated income tax return, the transferee steps into the shoes of the transferor for purposes of applying section 197 regarding the amount of the transferor’s adjusted basis that does not exceed the transferor’s adjusted basis in the section 197 intangible.28 The Treasury secretary is authorized to issue regulations as may be

22Section 197(d).

23Section 197(e).

24Section 197(c)(1). Two transition rules permitted elections regarding the effective date. A retroactive election was available to apply the newly enacted section 197 to property acquired after July 25, 1991, and on or before August 10, 1993. Temp. reg. section 1.197-1T(c). A separate election was available to apply prior law to property acquired under a written, binding contract in effect on August 10, 1993, and at all times thereafter through the date of acquisition of the property. Temp. reg. section 1.197-1T(d).

25Section 197(c)(2); reg. section 1.197-2(d)(2)(iii).

26Section 197(b).

27Id.

28Section 197(f)(2); reg. section 1.197-2(g)(2).
appropriate to carry out the purposes of section 197, including to prevent the avoidance of section 197 through related persons or otherwise.29

B. The Antichurning Rules of Section 197(f)(9)

1. Generally. Section 197(f)(9) contains antichurning rules that exclude from the definition of amortizable section 197 intangible certain intangibles acquired in certain transactions. The conference report on section 197 states that those rules were enacted to “prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under [prior] law into amortizable property.”30 Those rules have been explained and expanded through statutorily authorized Treasury regulations, are extremely complex (with several cross-references), and, in the author’s view, serve as an enduring and unnecessary trap for the unwary.

The antichurning rules apply to except from the definition of amortizable section 197 intangible any otherwise amortizable section 197 intangible for which depreciation and amortization deductions would not have been allowed under prior law,31 including specifically goodwill and going concern value if (1) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the transition period),32 by the taxpayer or a related person; (2) the taxpayer acquired the intangible from a person who held it during the transition period, and the user of the intangible does not change as part of the transaction; or (3) the taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period, but only if the transaction in which the taxpayer...
only brothers and sisters, spouse, ancestors, and lineal descendants; and (3) an individual owning (otherwise than by the application of (2)) any stock of a corporation is considered as owning the stock owned, directly or indirectly, by or for the individual’s partner (the partner stock attribution rule). Stock constructively owned by reason of clause (1) of the preceding sentence is treated as actually owned by that person for purposes of applying the constructive ownership rules to treat another as the owner of the stock.36

b. Section 707(b)(1). Section 707(b)(1) defines “related persons” to include the following:
- a partnership and a person owning, directly or indirectly, more than 20 percent of the capital or profits interest in the partnership; or
- two partnerships in which the same persons own, directly or indirectly, more than 20 percent of the capital or profits interests.

The constructive ownership rules that apply for purposes of section 267(b), other than the partner stock attribution rule, also apply for purposes of section 707(b)(1).37

c. Common control.38

i. Controlled group of corporations. Section 41(f)(5) provides that the term “controlled group of corporations” has the meaning given to it by section 1563(a), with “more than 50 percent” substituted for “at least 80 percent” in section 1563(a)(1), without taking into account section 1563(a)(4) and (e)(3)(C). A controlled group of corporations includes any of three groups: a parent-subsidiary controlled group, a brother-sister controlled group, and a combined group.39 A parent-subsidiary controlled group consists of one or more chains of corporations connected with a common parent corporation through stock ownership of at least 50 percent by vote or value, as long as the common parent owns at least 50 percent by vote or value of at least one of the other corporations, excluding from the calculation stock owned directly by any intermediary corporation.40 A brother-sister controlled group consists of two or more corporations in which five or fewer persons who are individuals, estates, or trusts (1) own 80 percent or more by vote or value of each corporation; and (2) own more than 50 percent by vote or value of each corporation, taking into account each person’s ownership only to the extent of their smallest holding in any of the brother-sister corporations.41 A combined group consists of three or more corporations, each of which is a member of a parent-subsidiary controlled group or a brother-sister controlled group, and one of which is (1) a common parent corporation of a parent-subsidiary controlled group and (2) included in a brother-sister controlled group.42 In making determinations regarding controlled groups of corporations, the excluded stock rules of section 1563(c) apply, which generally exclude nonvoting preferred stock and treasury stock.43 Finally, constructive ownership rules may provide for attribution. For parent-subsidiary controlled groups, the following rules apply:44
- stock is treated as owned by a corporation if the corporation has an option to acquire the stock;
- stock is treated as owned by a partner that owns an interest of 5 percent or more (by capital or profits) in a partnership that owns the stock, to the extent of the partner’s interest in the partnership; and
- stock owned by or for an estate or trust is treated as owned by any beneficiary who has an actuarial interest of 5 percent or more in the stock, to the extent that actuarial interest; and stock owned by or for any portion of a grantor or other similar trust is treated as owned by the grantor.

For brother-sister controlled groups, the same rules apply, with the addition of the following rules:45
- stock owned by or for a corporation is treated as owned by any person who owns 5 percent or more in vote or value of the corporation, to the extent of that person’s ownership interest;
- stock is treated as owned by an individual if the stock is owned by or for the individual’s spouse, unless the spouse has unfettered control of disposition of the stock and the individual does not have any of various connections to the corporation;
- stock is treated as owned by an individual if the stock is owned by or for the individual’s children who are under 21 years of age; and if the individual is under 21, any stock owned by the individual’s parents is treated as owned by the individual; and
- if an individual owns more than 50 percent of the total combined vote or value of stock in a corporation, the individual is treated as owning the stock in that corporation owned by or for his parents, grandparents, grandchildren, and children who are at least 21 years of age.46

ii. Trades or businesses under common control. The term “trades or businesses under common control”...
means any group of trades or businesses that is either a parent-subsidiary group under common control, a brother-sister group under common control, or a combined group under common control.47 The rules refer to the term “organization,” which means a sole proprietorship, partnership, trust, estate, or corporation, and an organization may be a member of only one group of trades or businesses under common control.48

A parent-subsidiary group under common control consists of one or more chains of organizations that are connected through ownership of a controlling interest with a common parent organization, in which a controlling interest means more than 50 percent ownership by vote or value of a corporation or more than 50 percent of the capital or profits interest in a partnership, if (1) a controlling interest in each of the organizations, except the common parent organization, is owned by one or more of the other organizations; and (2) the common parent organization owns a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by the other organizations.49 The above calculations are made with options to acquire outstanding stock of a corporation treated as exercised.50

A brother-sister group under common control consists of two or more organizations if (1) the same five or fewer persons who are individuals, estates, or trusts own a controlling interest of each organization; and (2) those persons are in effective control of each organization, taking into account each person’s ownership only to the extent of their smallest holding in any of the organizations.51 “Controlling interest” for those purposes means more than 80 percent ownership by vote or value of a corporation or of the capital or profits interests in a partnership, and “effective control” means 50 percent ownership by vote or value of a corporation or of the capital or profits interests in a partnership.52

A combined group under common control consists of a group of three or more organizations in which (1) each organization is a member of either a parent-subsidiary group under common control or brother-sister group under common control, and (2) at least one organization is the common parent organization of a parent-subsidiary group under common control and also a member of a brother-sister group under common control.53 In making determinations regarding trades or businesses under common control, both the excluded stock rules and constructive ownership rules similar to those detailed above for controlled groups of corporations apply.54

d. Timing of determination. The determination of whether persons are related is made both immediately before and immediately after the acquisition of the section 197 intangible.55 In the case of a series of related transactions, or a series of transactions that together comprise a qualified stock purchase under section 338(d)(3), the determination is made immediately before the earliest transaction in the series of transactions and immediately after the last transaction in the series of transactions.56

e. De minimis rule. Two corporations are not treated as related for purposes of the antichurning rules if (1) they would be treated as related persons solely by substituting “more than 20 percent” for “more than 50 percent” in applying section 267(f)(1)(A), which defines the term “controlled group”; and (2) each corporation possesses a beneficial ownership interest in the other’s stock of less than 10 percent of the total vote and value of all shares outstanding.57 For purposes of applying this rule, the constructive ownership rules of section 318(a) apply, but (1) in applying the attribution “from corporations” rule of section 318(a)(2)(C), the 50 percent limitation does not apply; and (2) in applying the attribution “to corporations” rule of section 318(a)(3)(C), 20 percent is substituted for 50 percent.58

f. Interaction with nonrecognition transactions. Although a transferee in a nonrecognition transaction would generally step into the shoes of the transferor for purposes of applying section 197, the antichurning rules prevent amortization of a section 197 intangible, even if it was amortizable in the hands of the transferor before the transaction, if immediately after the transaction (or series of transactions) in which the intangible was acquired, the transferee was related to any person who held or used the intangible during the transition period.59

3. Partnership rules. If there is an increase in the basis of partnership property under section 732, 734, or 743, for purposes of applying the “related person” rules, each partner is treated as having owned and used its proportionate share of the partnership’s assets.60 In those cases, the partnership is treated as an aggregate, rather than as an entity, for purposes of applying the antichurning rules. In all other partnership situations, the antichurning rules are generally applied at the partnership level, rather than at the partner level.61

a. Section 743(b). If a partnership interest is sold or transferred on death and the partnership has in effect an election under section 754 (a section 754 election) or one is made for the tax year in which the transfer occurs or the partnership has a substantial built-in loss immediately after the transfer, the basis of partnership property

47Reg. sections 1.41-6(a)(3)(ii) and 1.52-1(b).
48Id.
49Reg. section 1.52-1(c).
50Reg. sections 1.52-1(c)(1) and 1.1414(c)-4(b)(1).
51Reg. section 1.52-1(d)(1).
52Reg. section 1.52-1(d)(2) and (3).
53Reg. section 1.52-1(e).
54See section 52(b); reg. sections 1.52-1(g) and 1.1414(c)-3.
is adjusted with respect to the transferee. The antichurning rules apply to those basis adjustments only if the transferee is related to the transferor, and they do not apply based on the transferee's relationship to the partnership or other partners.

Also, in accordance with the exception to the antichurning rules for transfers on death in which basis is determined under section 1014 (discussed further below), the antichurning rules do not apply when a section 743(b) basis adjustment is made by reason of the death of a partner, with the new partner's basis determined under section 1014(a). In that situation, the new partner is treated for purposes of the antichurning rules as acquiring the interest from an unrelated person.

b. Section 732(d). Section 732(d) permits a partner that receives a distribution of property other than money within two years of the partner’s acquisition of the partnership interest from a partnership that did not have in effect a section 754 election at the time of the distribution to elect to treat the basis of that property as it would have been treated had the section 754 election been in effect. For purposes of the antichurning rules, adjustments under section 732(d) are analyzed as if the section 754 election had been in effect at the time of the acquisition of the partnership interest.

c. Section 732(b). On a partnership's distribution of property to a partner in liquidation of the partner’s interest in the partnership, the partner’s basis in the property other than money distributed to the partner is equal to the partner’s basis in its partnership interest (less any money received in the liquidating distribution). In accordance with the approach of treating each partner as owning and using its share of partnership intangibles, a liquidating distribution that includes an intangible is analyzed under the antichurning rules as if it were a transfer directly between partners — that is, the distributee partner is treated as receiving both its own share of the intangible and the share of each of the other partners. An increase in the basis of the distributed intangible is amortizable to the extent it does not exceed the other unrelated partners’ shares of unrealized appreciation.

The share attributable to the distributee partner (or any partner related to the distributee partner) may nonetheless be amortizable if that partner’s interest was “cleansed” by acquisition in a transaction that was not subject to the antichurning rules.

Despite application of the above rules, the antichurning rules may nevertheless continue to apply on a subsequent transfer of the intangible if the total unrealized appreciation of the intangible exceeds the section 732(b) basis adjustment at the time of the distribution (or if a portion of the intangible was otherwise not amortizable in the hands of the distributee).

d. Section 734(b). If partnership property is distributed to a partner and the partnership has in effect a section 754 election or one is made for the tax year in which the transfer occurs, or there is a substantial basis reduction with respect to the distribution, the basis of the partnership in its assets is adjusted to reflect the recognition of gain or loss by the distributee partner. For purposes of the antichurning rules, when a section 734(b) adjustment applies to an intangible asset held by a partnership, the transaction is analyzed as if each continuing partner acquired an interest in the intangible from the distributee partner. Provided the continuing partner is not the distributee partner or related to the distributee partner, the antichurning rules will not apply to the continuing partner’s share of any increase in basis in the intangible.

The continuing partner’s share of the increase in basis may also be amortizable if that partner’s interest was “cleansed” by acquisition in a transaction that was not subject to the antichurning rules.

e. Antiabuse rule. The special rules applicable to partnership basis adjustments contain their own antiabuse rule, which is intended to prevent taxpayers from circumventing the antichurning rules by transferring title without a corresponding change in the user of the intangible. If an “antichurning partner” or a related person (other than the partnership) becomes or remains a direct user of the intangible that is treated as transferred, then the antichurning rules apply to deny amortization to the extent that the antichurning partner is treated as having transferred the intangible. An antichurning partner means (1) regarding all intangibles held by a

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62Section 743(b). A partnership has a substantial built-in loss regarding a transfer of property if the excess of (1) the partnership’s adjusted basis in partnership property immediately after the transfer over (2) the fair market value of the partnership property is greater than $250,000. Section 743(d).

63Reg. section 1.197-2(h)(12)(v).

64Reg. section 1.197-2(h)(12)(viii).


66Reg. section 1.197-2(h)(12)(iii).


68Reg. section 1.197-2(h)(12)(ii)(i).

69Id.

70Reg. section 1.197-2(h)(12)(ii)(ii).

71Section 734(a) and (b). A substantial basis reduction exists if the sum of (1) the amount of any loss recognized by the distributee partner regarding the distribution under section 734(a)(2); and (2) for any distributed property to which section 734(b) applies, the excess of the basis of the distributed property to the distributee partner (determined under section 732) over the adjusted basis of the distributed property to the partnership immediately before that distribution (as adjusted by section 732(d)) exceeds $250,000. Section 734(d).

72Reg. section 1.197-2(h)(12)(iv).

73Id.

74Id.

75Reg. section 1.197-2(h)(12)(vi).

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partnership on or before August 10, 1993, any partner to the extent that (a) the partner acquired its interest in the partnership on or before August 10, 1993, or (b) the partner's interest was acquired from a person related to the partner on or after August 10, 1993, and that interest was not held by any person other than persons related to the partner at any time after August 10, 1993; or (2) regarding any section 197 intangible acquired by the partnership after August 10, 1993, that is not amortizable with respect to the partnership, any partner to the extent that (a) the partner's interest in the partnership was acquired on or before the date the partnership acquired the section 197 intangible, or (b) the partner's interest was acquired from a person related to the partner on or after the date the partnership acquired the section 197 intangible and that interest was not held by any person other than persons related to the partner at any time after the date the partnership acquired the section 197 intangible.  

f. Section 704(c) allocations. If a partner contributes property to a partnership and its tax basis differs from its book value, the disparity must be borne by the contributing partner and not shifted to any other partner. The regulations under section 704 provide three methods for accomplishing this goal (although other methods may be acceptable): the traditional method, the traditional method with curative allocations, and the remedial allocation method. If a partner contributes an asset (to which the section 704(c) allocation rules apply) that was an amortizable section 197 intangible in its hands to a partnership, the partnership may generally use any of the allocation methods provided in section 704(c) with respect to the intangible, and the antichurning rules will not apply. If, however, a partner contributes a section 197 intangible that was not an amortizable section 197 intangible in its hands to a partnership, a noncontributing partner may receive only remedial allocations of amortization regarding the intangible, and only if (1) the noncontributing partner is not related to the partner that contributed the intangible; and (2) as part of a series of related transactions that includes the contribution of the section 197 intangible to the partnership, the contributing partner or a related person (other than the partnership) does not become or remain a direct user of the contributed intangible.

4. Exceptions. The antichurning rules do not apply to acquisitions of section 197 intangibles by reason of death when basis is increased under section 1014(a). Also, the antichurning rules do not apply if the intangible was an amortizable section 197 intangible in the hands of the transferor before an acquisition, and the acquisition and the transaction in which the transferor acquired the intangible are not part of a series of related transactions.

If the antichurning rules would otherwise apply to an acquisition, those rules will not apply if (1) the buyer would not be related to the seller but for the substitution of 20 percent for 50 percent in the related person rules; (2) the seller elects to recognize gain on the sale of the section 197 intangible; and (3) the seller, regardless of whether it is otherwise subject to tax, pays federal income tax on the gain at the highest rate imposed by section 1 (for non-corporate taxpayers) or section 11 (for corporations and tax-exempt entities). The antichurning rules will apply to the extent that the buyer's basis in the intangible exceeds the seller's recognized gain. Finally, the antichurning rules will not apply when an election is made under section 338 to treat a stock purchase as an asset purchase for U.S. federal income tax purposes, provided the new corporation deemed to have been created as a result of the election is not otherwise treated as related to the acquired corporation.

5. The general antiabuse rule. A section 197 intangible that would otherwise qualify for amortization under section 197 will not qualify if one of the principal purposes of the transaction in which it is acquired is to avoid the requirement that the intangible be acquired after August 10, 1993, or to avoid the operation of the antichurning rules. A transaction will be presumed to have such a prohibited purpose if the acquisition does not effect a significant change in the ownership or use of the intangible. For example, if a section 197 intangible is acquired in a transaction (or series of related transactions) in which an option to acquire stock is issued to a party to the transaction, but the option does not trigger related person status under the antichurning rules, the antiabuse rule may apply.

III. Practicality and Fairness

Recently, issues regarding the amortization of basis increases in goodwill have arisen in connection with transactions in which investment management, private equity, or hedge fund firms have engaged in initial public offerings (IPOs). Some of those entities were, before their IPOs, classified as partnerships for U.S. federal income tax purposes, but used a corporate entity to go public, using an umbrella partnership real estate investment trust (UPREIT), or UP-C, structure. A new C corporation would be created. That C corporation would sell shares to the public, and the cash raised by the C corporation would be used to purchase interests in the partnership from the existing owners. The partnership...
would make a section 754 election for the year of the sale (if it did not already have one in place), and the C corporation would obtain a basis step-up for the portion of the assets of the partnership that it was treated as acquiring. The existing partners would also have the right, over time, to exchange their interests in the partnership for interests in the C corporation so that they could obtain liquidity. Those later exchanges of partnership interests for stock in the C corporation would be taxable transactions for U.S. federal income tax purposes.

Most of the value attributable to those types of businesses is goodwill, such that the basis step-up to the C corporation was primarily reflected in a section 197 intangible, and the amortization deductions associated with that basis increase would have significant value. Because the investment bankers believed the public would not pay for the value of the amortization deductions through a higher price per share on the IPO, the C corporation would enter into a tax receivables agreement with the selling partners under which the C corporation would be required to pay 85 percent of the tax benefit provided by the amortization deductions arising from the initial sale of partnership interests to the C corporation and from future taxable conversions of partnership interests to stock of the C corporation by the sellers of the partnership interests. Those payments would be treated as additional purchase price regarding the partnership interests, and because they were made after the year in which the sale or exchange occurred, a portion of each payment would be treated as interest. The portion of each additional payment that was treated as additional purchase price would further increase the basis in the intangible. Because of the significant value attached to these amortization deductions, it was necessary to ensure that in the case of a business that existed on or before August 10, 1993, the antichurning rules did not apply. Those IPOs were done to provide liquidity to the existing partners, to create a publicly traded security that the business could use to compensate its employees, and, in the case of IPOs that were primary offerings rather than secondary sales, to raise capital for the business. None of those IPOs were undertaken with a principal purpose of converting existing goodwill into an amortizable asset. Those IPOs would have been undertaken even if the amortization deductions associated with the increase in the basis of the goodwill were not available.

In those situations, because the basis increase arose under section 743, the antichurning analysis was applied to determine whether the C corporation was related to any of the continuing partners in the partnership. Because the ownership structure of the partnership might itself have been complex with partnership interests held by upper-tier partnerships and overlapping ownership among those partnerships, the application of the related person rules, with their inherent complexity and all of their cross-references and modifications, became daunting. Although tax practitioners generally do not shy away from applying complex rules, the time and effort expended in navigating those rules is not well-spent given that the antichurning rules themselves are, from a policy perspective, no longer necessary. The antichurning rules apply to intangible assets that were held by the taxpayer on or before August 10, 1993 (and on or after July 25, 1991). Over time, it is likely that the value of any such intangible asset has changed significantly, whether increasing or decreasing. It would seem unlikely, although not impossible, that taxpayers would engage in sales of businesses to related persons to achieve an amortizable increase in the basis of their intangible assets rather than for valid business reasons, as was the case in the IPOs described above.

Also, the antichurning rules can apply only to businesses that existed on August 10, 1993. If a business was started on or before August 10, 1993, such that a section 197 intangible had already been created by August 10, 1993, the antichurning rules could apply at any point in the future; whereas if the same business was started on August 11, 1993, the antichurning rules could never apply. This potentially disparate treatment of entities created at different times now appears capricious and unfair.

Finally, if the antichurning rules were to apply to prevent a section 197 intangible from being an amortizable section 197 intangible, the rules would apply not only to prevent the amortization of the value of intangible assets subject to the antichurning rules as of August 10, 1993, but to all of the increase in value of the intangible assets since then. This result is also unfair, business that was characterized as capital gain rather than ordinary income would flow through to the partners and be taxed at the lower rates applicable to capital gains; (2) the partners’ bases in their partnership interests would increase as income of the partnership was allocated to them, thereby reducing gain on a future exchange of interests for stock; and (3) in the case of a dividend-paying stock, a second level of tax could be avoided if the distributions from the operating partnership were made directly to the partners in the partnership rather than having to pass through a C corporation.

91To reflect the additional basis, the adjusted basis of the intangible is increased as of the beginning of the month of the addition, and the additional amount, if amortizable, is amortized ratably over the remaining months in the original 15-year period. Reg. section 1.197-2(f)(2)(i). Legislation was proposed, but not enacted, in 2007 that would have caused any gain recognized by the sellers to be treated as ordinary income rather than capital gain for transactions in which there existed a tax receivables agreement. H.R. 3996, 110th Cong. (1st Sess. 2007).
92The UP-C structure described above, in which the existing partners retained their interests in the original partnership rather than converting their partnership interests to corporate stock in a nonrecognition transaction under section 351 at the time of the creation of the C corporation, provided the following tax benefits to the existing partners: (1) income earned by the (Footnote continued in next column.)
IV. Same Economics, Different Tax Consequences

Since the early 1990s, when it started becoming widespread for states to adopt limited liability company statutes,97 the check-the-box regulations were promulgated,98 and some aspects of the U.S. federal income tax treatment of single-member and multiple-member LLCs in Rev. Rul. 99-599 and Rev. Rul. 99-6 were clarified,100 the use of LLCs to operate privately held businesses has proliferated. An LLC is classified, for U.S. federal income tax purposes, as either (1) an entity disregarded from its owner (a disregarded entity) if it has a single member or (2) as a partnership if it has more than one member.101 Operating as an LLC is desirable because an LLC provides the limited liability of a corporation, avoids the double taxation associated with C corporations, and provides more flexibility in terms of the ability to divide the economics among its equity owners than an S corporation, which can have only one class of stock.102 An LLC also enables its owners to deliver a basis step-up in the assets of the LLC when interests in the LLC are sold.

For an LLC that is treated as a disregarded entity, a taxable acquisition of an interest in the LLC is treated as an asset purchase,103 and for an LLC that is classified as a partnership, a taxable acquisition of an interest in the LLC from another member will provide a basis adjustment under section 743(b) if the LLC has in effect, or makes for the tax year in which the acquisition occurs, a section 754 election. The ability to deliver a step-up in the basis of its assets to a buyer can have major pricing implications in the context of a sale of a business. Not only is the buyer potentially able to amortize the higher basis in the tangible assets, but under section 197, to the extent that a portion of the purchase price is allocable to goodwill or going concern value,104 the purchaser would generally expect to be able to amortize that amount on a straight-line basis over 15 years. In many cases, most of the value of a business is allocated to goodwill or going concern value.105 The value of those amortization deductions in reducing the U.S. federal income tax liability of the new owners of the business can therefore significantly increase the price a purchaser would be willing to pay for the business. Because of this significant value, the ability to amortize the goodwill or going concern value has become an issue in many acquisitions, in which it is important to ensure that the antichurning rules of section 197(f)(9) do not apply to an acquisition for the purchaser to get the value for which it has bargained.

As discussed above, the antichurning rules are generally designed to prevent the amortization of goodwill when it would not otherwise be amortizable through sales to related parties, and provide complicated rules for determining when this has occurred. The rules, however, with their focus on form, are overbroad and prevent the amortization of goodwill following bona fide third-party purchases of businesses, rather than just serving the legitimate purpose of preventing tax avoidance.

This is best illustrated by an example that shows how one can achieve different results in two transactions that are almost identical from an economic perspective, with the antichurning rules seeming to constitute a trap for the unwary or unlucky. In the first situation, a woman started a business in 1990 that she operated as a sole proprietorship and that she contributed to a single-member LLC in 2000. When her son graduated from medical school in 2004, she transferred to him as a gift a 1 percent interest in the LLC, even though she was disappointed that he would not be joining the business.106 All of the income, gain, loss, and deductions of the LLC were shared by the mother and the son in the ratio of 99 to 1. In 2006 an unrelated private equity (PE) fund wanted to buy the business, but wanted the mother to retain a 25 percent equity stake in the business because she would continue to operate the business after the acquisition. Accordingly, the PE fund purchased the son’s entire interest in the LLC and an additional 74 percent of the equity of the LLC from the mother.

Assuming that the LLC had in effect, or made for the year of the acquisition, a section 754 election, the PE fund should be entitled to a basis step-up in the portion of the assets of the LLC attributable to its ownership interest in the LLC under section 743(b) that it would then seek to amortize or depreciate to offset the future taxable income generated by the LLC.107 Because a portion of the assets being acquired constitutes goodwill, it is necessary to

Footnote continued on next page.
ensure that the antichurning rules do not prevent the amortization of the goodwill. The general rule in section 197(f)(9) provides that the goodwill will not be treated as an amortizable section 197 intangible if “the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person.” Under this general rule, the PE fund would be the taxpayer, and under the related person rule of section 707(b)(1), the LLC would be treated as a related person regarding the PE fund because the PE fund owns more than 20 percent of the capital and profits interests in the LLC, so that the antichurning rules would normally apply to the acquisition. However, the special rule applicable to increases in the basis of partnership property under section 743 contained in section 197(f)(9)(E), which provides that determinations are made at the partner level and each partner is treated as having owned and used that partner’s proportionate share of the partnership assets, applies. As a result, it is the relationship between the “taxpayer,” that is, the PE fund, and the mother that must be tested. Because the mother is not related to the PE fund, the antichurning rules do not apply.

The facts of the second situation are the same as in the first except that in 2003, the PE fund approached the woman regarding a potential acquisition of the business. The woman owned all of the interests in the LLC because although she intended to gift to her son a 1 percent interest in the LLC on his graduation from medical school, he had not yet graduated. In this case, the PE fund purchased from the mother 75 percent of the interests in the LLC. Under Rev. Rul. 99-5, the purchase is treated as an acquisition by the PE fund of a 75 percent undivided interest in each of the assets of the LLC, followed by a contribution to a newly formed partnership of a 25 percent interest in each of the assets of the LLC by the mother (with no stepped-up basis) and a contribution of a 75 percent interest in each of the assets of the LLC by the PE fund (with a stepped-up basis) under section 721. In this situation, because the PE fund’s basis step-up did not arise under section 732, 734, or 743, the PE fund cannot rely on section 197(f)(9)(E) to avoid the antichurning rules. Under section 197(f)(2) and reg. section 1.197-2(g)(2), because the partnership acquired the intangible from a person in whose hands it was an amortizable asset in a transaction governed by section 721, the section 197 intangible contributed by the PE fund to the LLC should be amortizable by the LLC.

Reg. section 1.197-2(h)(10) and -2(k), Example 18, however, conclude that the antichurning rules apply not only to the portion of the intangible deemed contributed to the partnership by the mother, but also to the portion of the intangible deemed contributed to the partnership by the PE fund. Although the original deemed purchase of the assets was by a party (the PE fund) unrelated to the seller (the mother) such that the antichurning rules should not literally apply, at the end of the series of transactions that are deemed to occur under Rev. Rul. 99-5, the result reached is identical to that in section 197(f)(9)(A)(i), because the mother held the assets during the transition period and the mother and the partnership are related persons.108

This rule and the example in the regulations follow almost exactly the suggestion in the New York State Bar Association (NYSBA) Tax Section’s “Report on Issues to Be Addressed in Regulations Under Section 197.”109 The NYSBA report offered this fact pattern and concluded that the result under the statute — whether section 197(f)(9)(A)(i) should trump section 197(f)(2) — was unclear. Nevertheless, the NYSBA report suggested that for purposes of simplicity, the antichurning rules should apply, even though up to 80 percent of the deductions may be allocable to the new partner, because it would otherwise complicate the capital account maintenance rules if amortization were permitted for the new partner’s share of the intangible but not for the continuing partner’s share of the intangible. Despite the “simplicity” of the approach, the result, given the almost identical fact patterns and economics in the two situations described above — which are different only because of the timing of the PE fund’s purchase relative to the son’s graduation from medical school — seems patently unfair.110

One potential solution would be for a taxpayer to use a self-help mechanism in which the taxpayer would sell or transfer a portion of the LLC interest to form a new partnership before a sale to a third party. Given the form-driven nature of the antichurning rules, one would think this should be permissible. The NYSBA report discussed this type of situation as well — the creation of a partnership before a sale to a third party of an interest in the partnership for cash. The NYSBA report said the

108 Although the application of the rules is form-driven, the conclusion reached in the regulations is based on a substance-over-form step transaction approach. In contrast, if one acquires a section 197 intangible that was an amortizable section 197 intangible in the hands of the seller, and the transaction in which the intangible is acquired and the transaction in which the seller acquired the intangible are not part of a series of related transactions, the antichurning rules do not apply to the acquisition of the intangible, even if the acquirer is related to the party that sold the intangible to the seller. Reg. section 1.197-2(h)(5)(ii).

109 The difference between the fact pattern in the NYSBA report and the example in the regulations is that the NYSBA report says that the parties “previously contemplated” the drop-down at the time of the asset sale, and the regulation says that the drop-down occurred “immediately after” the asset purchase. One can assume that if the drop-down occurred immediately after the asset purchase, then it was contemplated at the time of the asset purchase. NYSBA, “Report on Issues to Be Addressed in Regulations Under Section 197” (Jan. 19, 1995), Doc 95-724, 95 TNT 12-20; reg. section 1.197-2(k), Example 18.

110 A question to ponder is whether the NYSBA report would have reached a different conclusion on this issue had the check-the-box regulations and Rev. Rul. 99-5, 1999-1 C.B. 434, already been issued, and the fact pattern described above become commonplace, when the NYSBA report was drafted. One with a revenue-raising mindset could, of course, argue that this disparate treatment could also be eliminated through the repeal of the generally taxpayer-favorable rule in section 197(f)(9)(E).
choice of form should not implicate the antichurning rules, even though the result was the same as under the facts referenced in section 197(f)(9)(A)(i) and the situation in which there is a disguised sale to a partnership. The NYSBA report recommended, and Example 17 of reg. section 1.197-2(k) ultimately confirmed, that the antichurning rules apply. The regulations under section 197 adopted the proposal of the NYSBA report in modified form. Reg. section 1.197-2(k), Example 19, provides that if a taxpayer forms a partnership with an affiliate and “in a subsequent year, in a transaction that is properly characterized as a sale of a partnership for Federal income tax purposes,” sells an interest in the partnership to a third party (and the partnership has in effect a section 754 election or one is made for the tax year in which the purchase of the partnership interest occurs), the third-party purchaser may amortize the basis increase in a section 197 intangible held by the partnership. It is left for the taxpayer to determine whether the step transaction doctrine might apply to conclude that the sale is not properly characterized as a sale of a partnership interest for U.S. federal income tax purposes in a situation in which the partnership was formed in contemplation of the sale. Also, the example in the regulations states that the sale of the partnership interest to a third party occurred in a year after the year in which the partnership was formed, suggesting that some time may need to pass between the formation of the partnership and the sale of the partnership interest to rely on the favorable conclusion reached in the example. The description of the fact pattern in the example makes it less useful in many of the situations encountered by tax practitioners.111

V. Antichurning Rules Drive the Economic Deal

Even more troubling are situations, such as the one described below, in which parties to a legitimate business transaction are forced to alter the economic deal to which they agreed to avoid the application of the antichurning rules.

A PE fund wanted to acquire an interest in an existing LLC (Opco LLC) that had been formed before August 10, 1993, and was owned equally by a father and son. The father was planning to retire, but the son wanted to continue to operate the business after the acquisition by the PE fund. To align the interests of the son with those of the PE fund, the PE fund wanted the son to retain a 25 percent interest in Opco LLC. A portion of the purchase price was to be financed using debt, and the remainder with equity supplied by the PE fund.112 In connection with the loan, the lenders wanted to obtain a lien on all of the assets of Opco LLC and a pledge of all of the interests in Opco LLC. Also, the PE fund wanted to ensure it had the unilateral ability to force a sale of the business to a third party without having to rely on a “drag along” right in the operating agreement of Opco LLC. To accomplish both of these goals, it was determined that Opco LLC should become a wholly owned subsidiary of a holding company LLC (Holdco LLC) and that Holdco LLC should be owned 75 percent by the PE fund and 25 percent by the son. That way, Holdco LLC could pledge to the bank all of the equity of Opco LLC rather than receiving a separate pledge of interests in Opco LLC from the PE fund and the son. Also, the PE fund, which was in control of Holdco LLC, could itself cause Holdco LLC to sell all of the interests in Opco LLC to a purchaser.

From a U.S. federal income tax perspective, this could easily be accomplished by having Opco LLC transfer all of its assets and liabilities to a newly formed LLC in exchange for interests in the newly formed LLC. That transaction would be disregarded for U.S. federal income tax purposes because the newly formed LLC would be a disregarded entity for U.S. federal income tax purposes. The newly formed LLC would then become the operating company, and Opco LLC would become Holdco LLC. The PE fund could then purchase 75 percent of the interests in Holdco LLC and would be entitled to a basis step-up under section 743(a), assuming a section 754 election were in place or were made by Opco LLC for the year in which the transaction occurred, and the portion of the goodwill of the business indirectly purchased by the PE fund would be amortizable by the PE fund. Such a structure would have been impractical, if not impossible, from a corporate law perspective because it would have required an asset transfer and obtaining all of the attendant consents.

Instead it was determined that the PE fund would create a new LLC, Holdco LLC. The PE fund would contribute the cash that would be used to purchase the interests in Opco LLC to Holdco LLC. The formation of Holdco LLC and the contribution of cash to Holdco LLC would be disregarded for U.S. federal income tax purposes because Holdco LLC would be wholly owned by the PE fund. It was then contemplated that the son would contribute a 25 percent interest in Opco LLC to Holdco LLC in exchange for a 25 percent interest in Holdco LLC, which would enable the son to retain his continuing interest in the business. The son’s contribution of this interest in Opco LLC to Holdco LLC in exchange for an

111This example changed from the proposed regulations under section 197 issued in 1997 to the final regulations that were issued in 2000. Notice of Proposed Rulemaking (REG-209709-94), 62 Fed. Reg. 2336 (Jan. 16, 1997), prop. reg. section 1.197-2(k), Example 17; T.D. 8865, 65 Fed. Reg. 3820 (Jan. 25, 2000), reg. section 1.197-2(k), Example 19. In the proposed regulations, this example said that the taxpayer formed the partnership with an affiliate and that the partnership interest was sold in an unrelated transaction. That language implied that if the partnership were formed in connection with the sale to the third party, no amortization would be permitted. The preamble to the final Treasury regulations stated that, in response to comments that the concept of an unrelated transaction creates a new standard for making determinations, the language of the example was changed and that existing step transaction principles would apply to making the determination of whether amortization would be permitted. This change would not seem to alter the result in a material way, but effectively admits a substance-over-form standard into these formalistic rules to reach a result that is less favorable to the taxpayer.

112The use of debt and the implications of a basis step-up under section 734(b), while interesting to consider, are not necessary for purposes of this example.
interest in Holdco LLC would cause Holdco LLC to become a partnership for U.S. federal income tax purposes, with the PE fund treated as having contributed to the partnership the cash that was in Holdco LLC. Holdco LLC would then acquire all of the interests of the father and the remaining interests of the son in Opco LLC, such that Holdco LLC would own all of the interests in Opco LLC. When Holdco LLC acquired the 75 percent of Opco LLC that it did not already own, that transaction would be treated as an asset purchase for U.S. federal income tax purposes. Holdco LLC would have a stepped-up basis in 75 percent of each of the assets of Opco LLC as a result of the deemed asset purchase. Because Holdco LLC would be treated as related to the son, who maintained a 25 percent continuing interest in Holdco LLC, Holdco LLC would not be entitled to amortize the basis step-up attributable to the goodwill that was acquired. In this case, a transaction form that would have been undertaken for a valid business purpose, and when the same end result could have been achieved with amortization of the acquired goodwill if the corporate law issues associated with asset transfers did not exist, could not be used to achieve the desired result because of the application of the antichurning rules. Ultimately, the parties determined that to avoid the antichurning rules, the son would retain less than a 20 percent interest in Holdco LLC. The parties were required to change the business deal to achieve the amortization of the goodwill.

VI. Conclusion

The repeal of section 197(f)(9), the antichurning rules, would serve several important policy goals. Although many obstacles would remain, the repeal of section 197(f)(9) would be one small step toward tax simplification. It would promote fairness by eliminating the disparate treatment of taxpayers acquiring section 197 intangibles that were created on or before August 10, 1993, and taxpayers acquiring intangibles that were created after that date, as well as the inability to amortize section 197 intangibles in the intervening period, one would expect the relative loss of revenue to the government resulting from a repeal of section 197(f)(9), as compared to the compromise position, to be insignificant.

113 Supra note 99.
114 Supra note 100.
115 Holdco LLC would not obtain a basis step-up regarding the portion of the assets of Opco LLC that were deemed to have been contributed to Holdco LLC in connection with the formation of the Holdco LLC partnership.
116 Reg. section 1.197-2(k), Example 17.
117 The transaction could also have been structured by having Holdco LLC purchase the LLC interests from the father and the son before the son’s contribution of the Opco LLC interests to Holdco LLC. In that case, Holdco LLC would have acquired an interest in a partnership and a basis step-up under section 754, assuming a section 754 election was in effect or was made for the year of the acquisition. However, given that the two transactions would be occurring under a plan, the concern was that the IRS would view both the purchase of the partnership interests and the contribution of the Opco LLC interests by the son to Holdco LLC as a single asset acquisition, resulting in the same U.S. federal income tax consequences as discussed above.
In-House Advertisement
Intentionally Removed
A. Introduction

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) added to the Internal Revenue Code a substantive liability for dispositions of U.S. real property interest under section 897 of the code.¹ In 1984 a complementary withholding tax regime was added in section 1445.² Both the statutes and their underlying regulations are extremely complex and cover a wide range of circumstances. This article is concerned only with the limited circumstances in which foreign-owned U.S. corporate groups may run afoul of these rules for failure to provide timely information between members of the group when certain events occur and to notify the Internal Revenue Service. In particular, it is our view that the remedial reporting rules adopted in Rev. Proc. 2008-27³ as a preliminary substitute for the increased number of taxpayer requests for relief under reg. section 301.9100-1 and reg. section 301.9100-3⁴ regarding the FIRPTA regime are inadequate as applied to the circumstances discussed in this article. The limited foreign controlled U.S. corporate group circumstances we consider would be more effectively dealt with by regulations that created a presumption of FIRPTA liability in these circumstances that could be rebutted on audit of the domestic corporate group.

The simplest paradigm for our foreign controlled U.S. corporate group is the circumstance in which a foreign corporation (FP or FS) owns 100 percent⁵ of a domestic corporation (US), and US either owns no real property interests in the United States, or plainly falls below the 50 percent fair market value threshold for a U.S. real property holding corporation (USRPHC) set forth in section 897(c)(2).⁶ Our simplified potential tax triggers include FP (or FS) reorganizing the US holdings outside the United States, receiving a distribution from US in excess of its earnings and profits, or making a distribution regarding its interest in US. The statutes and regulations create a binding presumption of tax liability in these circumstances unless US provides a timely written statement to the foreign transferee that it is not a USRPHC under section 897(c)(2) and notifies the IRS within a specified period of time (the statement/notice/procedural requirements).⁷

Failure to timely comply with these procedural requirements could trigger U.S. tax on the entire gain realized on the transfer, as well as interest and penalties.

¹FIRPTA was part of the Omnibus Reconciliation Act of 1980. Section 1122(a) of that public law added section 897 to the Internal Revenue Code. Unless otherwise indicated, all references to “section” or “sections” herein are to the Internal Revenue Code of 1986, as amended as of the relevant date; all references to “reg.,” “temp. reg.,” or “regulations” are to regulations of the U.S. Department of Treasury, as most recently adopted, proposed, or amended as of the relevant date.
²Tax Reform Act of 1984, section 129(a)(1) (adding section 1445 effective for any disposition on or after January 1, 1985). In 1980 the Senate version of the bill contained a withholding provision, but it was dropped in conference to carefully structure the withholding provision. Enactment of a withholding provision was further delayed in part by a delay in reporting regulations under sections 897 and 6039C.
⁴Reg. section 301.9100 provides a mechanism under which the commissioner may grant extensions for some filing failures upon demonstration of reasonable action and good faith.
⁵Our analysis should apply equally to an 80 percent controlled group as defined in section 1504(a), but without regard to section 1504(b)(3). As discussed herein, this is the definition adopted in the section 7874 regulations, and we believe it would adequately address most circumstances that we are aware of when these issues arise.
⁶Section 897(c)(2) defines USRPHC as any corporation if (A) the FMV of its U.S. real property interest equals or exceeds 50 percent of (B) the FMV of (1) its U.S. real property interests, (2) its interests in real property located outside the United States, plus (3) any other of its assets that are used or held for use in a trade or business. For purposes of FIRPTA, real property interests include not only ownership of traditional real estate interests such as land, improvements, and structures, but also movable walls, furnishings, and other personal property associated with the use of real property. Section 897(c)(6); reg. section 1.897-1(b); see also Announcement 2008-115, 2008-48 IRB 1228, Doc 2008-25185, 2008 TNT 231-6 (announcing the publication of a notice of proposed rulemaking (REG-130342-08) on the definition of an interest in real property under section 897(c), addressing the rights granted by a government unit that are related to the lease, ownership, or use of real property).
⁷The tax liability and procedural requirements are discussed in more detail below.

"Facts do not cease to exist because they are ignored."

— Aldous Huxley, Proper Studies (1927)
The amounts at issue can be large, and even though the prospects are high for correcting the failure under Rev. Proc. 2008-27 or through the reg. section 301.9100 relief process, there is some risk that a request for more time could be denied, resulting in the imposition of tax. And because the taxpayer subject to U.S. tax on the gain under section 897 is a foreign corporation that typically has not filed U.S. returns because it is not otherwise subject to U.S. tax, the statute of limitations remains open. Similarly, assuming that no withholding return has been filed reflecting the transaction, the statute of limitations on withholding tax liability also remains open.

Although taxpayers and practitioners are generally aware of the FIRPTA provisions, in our experience there has been frequent inattention to the procedural requirements, creating exposure to gain recognition when the disposition transactions relate to stock ownership of U.S. corporations that clearly fell below the 50 percent FMV threshold in section 897(c)(2) (the substantive rules). Although practitioners frequently check the FMV of real estate, they often overlook the procedural requirements necessary to avoid a FIRPTA tax on gains. These omissions created a flood of reg. section 301.9100 relief requests, starting in 2005 with a request for which the authors were responsible, and reaching a peak in 2007 and 2008.

Rev. Proc. 2008-27 is a response to these increasing requests and deflects them to Ogden, Utah, under a simplified procedure. Under the revenue procedure, the taxpayer’s submission is deemed to have established reasonable cause for late compliance if the taxpayer has not been notified within 120 days that the IRS has determined that its noncompliance was not supported by reasonable cause or that additional time is needed for the determination. Only if denied relief under the revenue procedure is the taxpayer required to file a private letter ruling application under reg. section 301.9100. It is too early to gauge how this process will be administered in practice, but, as discussed below, we believe more changes should be made to the regulations to address foreign controlled group situations more appropriately.

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8See recommendations below.
9Although in situations 2, 3, and 4 (illustrated below) it may be difficult for the IRS as a practical matter to collect any such tax (both the taxpayer and the withholding agent are foreign corporations, and their only U.S. asset is stock of US), few foreign-owned U.S. groups are willing to rely on uncollectibility to resolve the issue.
10Reg. section 1.897-2(b)(2) contains a presumption that the real property interests are less than 50 percent of the FMV if the book value of those interests is 25 percent or less of book value.
11The authors were reviewing the FIRPTA implications of a proposed distribution in excess of E&P by a U.S. corporation to its foreign shareholder. Our FIRPTA inquiry revealed a series of previous restructurings involving the U.S. stock, which required relief under reg. section 301.9100.
13See also Kenneth J. Krupsky, “New Relief for Failure to File No-Withholding FIRPTA Certificates: Secret Law?” 37 Tax Mgmt Int’l J. 685 (Nov. 14, 2008), raising the issue of private law developing at the service center level.
14A similar issue arises when FP sells the stock of FS and the buyer makes a section 338 election, which treats a stock purchase as an asset acquisition. That scenario presents additional issues regarding the proper application of the procedural requirements, given that the election likely postdates the date of disposition of the stock. See section 338(g)(1), providing that the election must be made no later than the 15th day of the 9th month beginning after the month in which the acquisition (Footnote continued on next page.)
C. A Brief Review of FIRPTA Rules

1. Substantive FIRPTA liability. Under section 897(a)(1), a foreign corporation is taxed on gain from the disposition of a United States real property interest under section 882(a)(1) as if it were engaged in a trade or business within the United States and the gain were effectively connected with that trade or business. Most of the problems we focus on are attributable to section 897(c)(1)(A)(ii), which defines a U.S. real property interest to include any interest in any domestic corporation (other than solely as a creditor), unless the taxpayer establishes in the time and manner directed by the Treasury regulations that at no time during the five-year period ending on the date of the disposition was it a USRPHC. As discussed in more detail below, the general rule for withholding under section 1445(a) is 10 percent of the amount realized on the disposition of a United States real property interest. A 10 percent rate applies specifically to section 301 distributions from a domestic corporation that is a USRPHC to a foreign person to the extent that the distribution exceeds E&P and to section 302 distributions of property to a foreign person.

The term “disposition” is broadly defined in reg. section 1.897-1(g) as “any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and regulations thereunder.” Reg. section 1.897-1(h) provides that gain or loss from a disposition of the United States real property interest is “the amount determined as provided in section 1001(a) and (b).” Also, that gain or loss is subject to section 897(a), unless a nonrecognition provision in section 897(d)(2) or (e) applies.

Section 897(d)(1) states that except as otherwise provided in regulations, a foreign corporation recognizes gain for section 897(a) purposes on its distribution (including a distribution in liquidation or redemption) of a U.S. real property interest in an amount equal to the excess of FMV of that interest over its adjusted basis. A 35 percent withholding rate applies to gain on these dispositions.

2. Binding presumption of USRPHC status. Pursuant to the regulatory authority in section 897(c)(1)(A)(ii), reg. section 1.897-2 sets forth the required proof of a domestic corporation’s exclusion from classification as a USRPHC. Reg. section 1.897-2(g)(1)(i) provides that the foreign corporation must establish that the domestic corporation is not a U.S. real property holding corporation as of the date of disposition, either by obtaining a statement from the domestic corporation in accordance with reg. section 1.897-2(g)(1)(ii), or by obtaining a determination by the commissioner under reg. section 1.897-2(g)(1)(iii). If the foreign person fails to implement either proof mechanism, the interest in the domestic corporation is presumed to have been a U.S. real property interest and the statutory liability is triggered.

Although presumptions in tax law are frequently rebuttable, this presumption appears to be binding, based on the structure and operation of the regulation. The private letter rulings regarding relief under reg. section 301.9100 confirm that this is the IRS’s interpretation of the rules. Reg. section 1.897-2(a) describes the structure of the regulation and states:

Paragraph (g) explains the manner in which an interest-holder can establish that a corporation is not a U.S. real property holding corporation, and paragraph (h) provides rules regarding certain notification requirements applicable to corporations.

The statement/notification mechanics for avoiding tax by establishing non-FIRPTA status are as follows. The foreign corporation requests and obtains from the domestic corporation a statement under penalties of perjury that an interest in the corporation was not a U.S. real property interest. To rely on a statement from the domestic corporation, the foreign person “must obtain the [domestic] corporation’s statement no later than the occurred. For instance, does old FS need to request a statement from US to give to itself (as new FS) when the deemed sale of the stock of US occurs?

15Net based taxation.
16FIRPTA has equal application to nonresident alien individuals. See section 897(a)(1)(A); section 897(a)(2).
due date, including any extensions, on which a tax return would otherwise be due regarding the disposition.\(^{22}\)

However, this statement is valid only if the domestic corporation complies with the notice requirements of reg. section 1.897-2(b)(2) (or -2(h)(4)). Reg. section 1.897-2(b)(2) requires that notice with certain information must be provided to the IRS at the FIRPTA unit in Philadelphia on or before the 30th day after the statement was mailed to the interest holder that requested it. Failure to provide the notice to the IRS within that time period will invalidate the statement provided to the interest holder under reg. section 1.897-2(b)(1).\(^{23}\) Under reg. section 1.897-2(h)(4), if the domestic corporation has provided a voluntary notice to the IRS with its last tax return and has not had an event described in reg. section 1.897-2(c)(1)(ii) - (iv) (acquisitions of realty or dispositions of trade or business assets), the notice does not need to be sent to the IRS. This rule does not eliminate the need for (1) the foreign corporation to request a statement of non-FIRPTA status from the domestic corporation, or (2) the domestic corporation’s statement of non-FIRPTA status to be given to the foreign corporation.

Reg. section 1.897-2(g)(1)(ii)(B) provides a coordination rule with section 1445 eliminating withholding liability for the transferee if it receives the corporation’s statement. As discussed below, the section 1445 rules generally require that the statement be received by the transferee before the transfer at issue, so that the statement requirements for section 1445 purposes typically must be satisfied earlier than may be required under section 897.

The taxpayer may also satisfy the proof requirements by obtaining a commissioner’s determination under reg. section 1.897-2(g)(1)(iii)(B), (C), or (D), but these rules are not typically applicable to the foreign controlled U.S. corporate group transactions we are focusing on here. The mechanics in (B) and (C) also require that the taxpayer make timely filings. For example, both (B) and (C) appear to contemplate situations in which the taxpayer has sought a statement from the U.S. corporation and has received no response from the U.S. corporation or has adequate information in its possession that would allow the commissioner to make the determination. Curiously, (D) appears to allow the commissioner upon his own motion to determine, at any time, that a U.S. corporation is not a USRPHC. Given that the commissioner previously has allowed taxpayers relief only through a reasonable cause showing under reg. section 301.9100-3 or Rev. Proc. 2008-27, it seems unlikely that the commissioner would unilaterally make that determination on a basis different from reasonable cause. We are unaware of any situation in which the commissioner has independently exercised this authority.

Accordingly, even where the controlled group knows that US is not a USRPHC because its real estate is too small a fraction of its business assets to be anywhere near the 50 percent threshold or the 25 percent or less book value test, FP (or FS) must timely request from its controlled US subsidiary a statement of a known fact, and the subsidiary must file an additional notice with the IRS to avoid the binding presumption of taxable gain.

3. The USRPHC determination. Determining whether a domestic corporation is a USRPHC at any time within the five years preceding the disposition is not as simple as just asserting that the domestic corporation cannot be a USRPHC because it holds insignificant real property in the United States or the U.S. Virgin Islands. The statement must be signed under penalties of perjury, which requires care in the determination process.

Under section 897(c)(2) and reg. section 1.897-2(b)(1), establishing non-USRPHC status by failing to meet the less than 50 percent test requires the domestic corporation to determine the FMV of its United States real property interests, its interests in real property located outside the United States (that is, foreign real property), and any other of its assets that are used or held for use in a trade or business.\(^{24}\)

For purposes of the FIRPTA rules, real property includes the following three categories of property: land and unsevered natural products of the land, improvements, and personal property associated with the use of real property.\(^{25}\)

The term “interest in real property” includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.\(^{26}\) An interest in real property other than an interest solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property, a time-sharing interest in real property, and a life estate, remainder, or reversionary interest in such property.\(^{27}\) The term also includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property.\(^{28}\)

The term “asset used or held in a trade or business” includes:

- Property, other than a U.S. real property interest, that is: “[s]tock in trade of an entity or other property of a kind which would properly be included in the inventory of the entity if on hand at

\(^{22}\)Id.

\(^{23}\)Reg. section 1.897-2(b)(2)(v).

\(^{24}\)The alternative book value test referred to above is found in reg. section 1.897-2(b)(2). Although this simple alternative is typically the preferred method, it is still difficult to comply with and often may not be available. It requires that the books be computed according to U.S. generally accepted accounting principles, rather than the international accounting standards more generally used by foreign-owned U.S. corporate groups. Also, the presumption as to the FMV of a corporation’s U.S. real property interests provided by the alternative test may be deemed in some circumstances, under reg. section 1.897-2(b)(2)(iii).

\(^{25}\)Reg. section 1.897-1(b)(1). Local law definitions will not be controlling for purposes of determining the meaning of the term “real property” as it is used in sections 897, 1445, and 6039C and the regulations thereunder. Id.

\(^{26}\)Section 897(c)(6)(A).

\(^{27}\)Reg. section 1.897-1(d)(2)(i).

\(^{28}\)Id; see also supra note 6.
the close of the taxable year, or property held by the entity primarily for sale to customers in the ordinary course of its trade or business,”30 or “depreciable property used or held for use in the trade or business, as described in section 1231(b)(1) but without regard to the holding period limitations of section 1231(b).”30

- “Goodwill and going concern value, patents, inventions, formulas, copyrights, . . . trademarks, trade names, franchises, licenses, customer lists, and similar intangible property, but only to the extent that such property is used or held for use in the entity’s trade or business and subject to the valuation rules of section 1.897-1(o)(4).”731

- “Cash, stock, securities, receivables of all kinds, options or contracts to acquire any of the foregoing, and options or contracts to acquire commodities, but only to the extent that such assets are used or held for use in the corporation’s trade or business and do not constitute U.S. real property interests.”32

- A proportionate share of the property, other than a United States real property interest, described in the above three categories that is owned by a partnership, trust, estate in which a person holds an interest, or that is owned by a corporation in which a person holds a controlling interest.33

The domestic corporation also must consider when to make its determination of status as a USRPHC. Once again, the determination date rules are far from simple. It can be as simple as at the end of each tax year.34 Or there may be multiple determination dates, such as the date of acquisition of any U.S. real property interest, the date on which the corporation disposes of foreign real property, or the date of disposition of certain trade or business assets.35

4. Withholding under section 1445. Section 1445(a) provides as a general rule that in the case of any disposition of a U.S. real property interest, as defined in section 897(c), by a foreign person (which includes foreign corporations and foreign partnerships),36 the transferee must deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.37

Section 1445(b) provides several exemptions to the general withholding rule of section 1445(a) that generally parallel the rules in section 897. Section 1445(b)(6) exempts the disposition of a U.S. real property interest if “the disposition is of a share of a class of stock that is regularly traded on an established securities market.”38 The regulations explain the scope of other exemptions by providing that in general, a transferee has a duty to withhold under section 1445(a) only if both of the following are true:

- the transferor is a foreign person; and
- the transferee is acquiring a U.S. real property interest.40

However, the transferee must comply with the procedures in the regulations to ascertain whether liability is relieved because one or the other of these two elements is missing.41 The procedures depend on the transaction at issue.42

35Reg. section 1.897-2(c)(1)(i) and (iii). These are additional determination dates because it is more likely that after such transactions the domestic corporation has become a USRPHC.

36For purposes of section 1445, the term “foreign person” means any person other than a United States person. Section 1445(f)(3). The term “United States person” is not defined in section 1445 or the regulations thereto. Section 7701(a)(3) defines a United States person as a citizen or resident of the United States, a domestic partnership, a domestic corporation, and some trusts and estates. Section 7701(a)(1) defines person as an individual, trust, estate, partnership, association, company, or corporation.

37The amount realized by the transferor of a U.S. real property interest is equal to the sum of (1) cash paid, or to be paid; (2) the FMV of other property transferred; and (3) the outstanding amount of liability assumed by the transferee or to which the transferred U.S. real property interest was subject to both before and after the transfer. Reg. section 1.1445-1(g)(3).

38Section 1445(e)(3) also imposes a withholding obligation under section 1445(a) in the case of certain distributions (that is, redemptions under section 302(a), taxable liquidating distributions under section 331, and a return of capital distribution under section 301(c)) from a U.S. real property holding corporation, as defined in section 897(c)(2).

39See reg. sections 1.1445-2(c)(2) and 1.1445-5(b)(4)(ii).

40Reg. section 1.1445-2(a).

41Id.

42For example, section 1445 has a parallel exception from withholding for some nonrecognition transactions. Under reg. section 1.1445-2(d)(2), a transferee is not required to withhold if the transferor provides notice to the transferee that, by reason of the operation of a nonrecognition provision of the code or the provisions of any U.S. treaty, the transferor is not required to recognize any gain or loss regarding the transfer. The notice must include the information described in reg. section 1.1445-2(d)(2)(iii). The transferee must provide a copy of the notice to
For purposes of this article, the procedure that parallels the section 897 statement process in the context of a foreign controlled group is section 1445(b)(3), which relieves the transferee’s withholding duty if the nonpublicly traded domestic corporation provides an affidavit stating, under penalty of perjury, that:

• the domestic corporation is not and has not been a U.S. real property holding corporation during the applicable period; or
• as of the date of the disposition, interests in such corporation are not U.S. real property interests by reason of section 897(c)(1)(B) (the so-called cleansing rule in which the corporation disposed of all of its U.S. real property interests in transactions in which all gain was recognized).

Under reg. section 1.1445-2(c)(3), section 1445(b)(3)(A) is satisfied if the transferor provides the transferee with the statement issued by the domestic corporation under penalties of perjury in accordance with reg. section 1.897-2(h). At the request of the transferor, the domestic corporation can provide the statement directly to the transferee. The transferor must request the statement before the transfer, and at the time of the transfer, the transferor or the transferee must have the statement in hand.

Section 1445(e) provides special rules for certain dispositions and distributions, including distributions by foreign corporations. Section 1445(e)(2) and reg. section 1.1445-5(d) provide that in the case of any distribution by a foreign corporation on which gain is recognized by the transferee, the foreign corporation can provide the statement directly to the transferee. Under section 1445(e)(3), the foreign corporation is required to withhold under section 1445(e) to withhold a tax equal to 35 percent of the amount of gain recognized. Withholding is not required if no gain is required to be recognized by reason of the operation of a nonrecognition provision or provision of any treaty of the United States, but only if notice requirements are complied with.

Withholding is also not required in two other circumstances. First, it is not required if the foreign corporation determines that the property distributed is not a U.S. real property interest. The foreign corporation must make that determination in compliance with the procedures in the regulations. Reg. section 1.1445-5(b)(4)(iii) provides one method involving the transferor’s receipt of the statement from the domestic corporation issued under reg. section 1.897-2(h), and reg. section 1.1445-5(b)(4)(ii) provides another method for interests in publicly traded entities. Second, withholding is not required regarding a foreign corporation’s distribution of a U.S. real property interest if the distributing corporation obtains a withholding certificate from the IRS under reg. section 1.1445-6.

5. Does absence of gain avoid the rules? Unfortunately, the absence of gain does not clearly remove the transaction from the scope of the rules. Although there would be no substantive tax liability and no related withholding tax liability in the absence of gain from the disposition, there is still potential exposure for interest under reg. section 1.1445-1(e)(3)(ii) from the date the withholding was required. The relief originally announced in Notice 2006-99 for potential exposure for interest and penalties, under reg. section 1.1441-1(b)(7) before amendment, for failure to withhold under section 1441 or 1442 when there was no substantive tax liability, was not extended to withholding under section 1445, and the regulations under section 1445 have not been amended.

The policy rationale for the changes to section 1441 appears to be based on the notion that withholding is simply a means of collecting what is otherwise the substantive tax and thus should not result in greater liability to the withholding agent than the substantive tax liability. Even though section 1445 withholding normally is applied at a 10 percent rate on the amount realized

the IRS within 20 days of the transfer. Reg. section 1.1445-2(d)(2)(i)(B). Similarly, in transfers described in section 1445(e), an entity or fiduciary otherwise required to withhold is not required to withhold if, by reason of the operation of a nonrecognition provision of the code or the provisions of any U.S. treaty, no gain or loss is required to be recognized by the foreign person with respect to which withholding would otherwise be required. Reg. section 1.1445-5(b)(2)(i)(A). Withholding is not required if, within 20 days of the transfer, the entity or fiduciary delivers a notice to the IRS that includes the information described in reg. section 1.1445-5(b)(2)(ii). See reg. section 1.1445-5(b)(2)(ii). Reg. section 1.897-2(g)(1)(ii)(B) provides a coordination rule with section 1445, such that the statement for section 897 satisfies the affidavit requirement of section 1445. Also, the domestic corporation could get such a determination from the IRS. Reg. section 1.897-2(g)(1)(ii). Reg. section 1.1445-2(c)(3)(i). Reg. section 1.1445-2(c)(3)(i).

Other special rules include: withholding on some dispositions of U.S. real property interests by a domestic partnership, domestic trust, or domestic estate (section 1445(e)(1)); withholding on distributions by some domestic corporations to foreign shareholders (section 1445(e)(3)); taxable distributions by domestic or foreign partnerships, trusts, or estates (section 1445(e)(4)); rules relating to dispositions of interests in such entities (section 1445(e)(5)); and some distributions by a regulated investment company or real estate investment trust (section 1445(e)(6)). These other special rules are not the subject of this article.

47Reg. section 1.1445-5(d)(1); reg. section 1.1445-5(b)(2).
48Reg. section 1.1445-5(d)(2).
49Id. The regulation’s cross-reference to (b)(3) should be to (b)(4).
50Reg. section 1.1445-5(b)(4)(iii)(A) refers only to the domestic corporation’s statement that the interest is not a U.S. real property interest. The regulation does not address a determination by the commissioner.
53See T.D. 9323, 72 Fed. Reg. 18,386 (Apr. 12, 2007), Doc 2007-3032, 2007 TNT 71-11, retroactively incorporating Notice 2006-99 into the regulations under section 1441 (and thus section 1442). Before T.D. 9323, reg. section 1.1441-1(b)(7)(iii) provided that a withholding agent that failed to withhold tax for reasons other than reliance on the appropriate presumptions is not relieved from liability for interest under section 6601. It further provided that such liability exists even when there is no underlying tax that is ultimately shown to be due.
without regard to the ultimate tax liability of the taxpayer, it is difficult to discern why the policy rationale would not apply to section 1445 obligations. As noted above, however, nothing explicitly exempts section 1445 liability for interest or potential penalties in these circumstances.\(^5^4\)

When a domestic corporation makes a distribution in excess of earnings and profits to a foreign shareholder, section 1445(e)(3) and reg. section 1.1445-5(e) require a withholding tax equal to 10 percent of the value of the amount distributed, without regard to any determination of whether the excess distribution exceeds the recipient’s basis in the stock of the domestic corporation. Although as illustrated in Situation 1, FP would not have a substantive tax liability under section 897, US’s failure to withhold potentially raises, again, the section 1445 interest and penalty exposures discussed above.

6. Surely there are some exceptions. Despite the shared knowledge of non-USRPHC status that is apparent in our foreign controlled U.S. corporate group paradigm, under the current regulation structure there are no applicable exceptions or exclusion that would avoid the need for timely compliance with the procedural requirement to avoid application of both sections 897 and 1445.

7. Zero current real property holdings. Section 897(c)(1)(B) excludes from the term “United States real property interest” any interest in a corporation if, at the date of disposition, the corporation has zero U.S. real property interests and all of the U.S. real property interests held by it during the five-year period ending on the disposition date were disposed of in taxable transactions. This appears to be a complete override, without required regulations, of the USRPHC status conferred by section 897(c)(1)(A)(ii) on interests in domestic corporations generally. Nevertheless, the regulations implementing (A) seem to override the statutory structure. Reg. section 1.897-2(a) makes paragraph (g) of that section the exclusive means of establishing an exemption. While reg. section 1.897-2(f) reiterates the statutory rule exempting domestic corporations with zero real property from the status conferred by (A), it seems reasonable to interpret the regulations as requiring compliance with the procedural rules of reg. section 1.897-2(g). Finally, the rule in (B) is referred to explicitly in the context of the statement requirement in reg. section 1.897-2(h)(1)(ii).

8. Publicly traded domestic stock. Section 897(c)(3) excludes from the definition of U.S. real property interest any class of stock of a domestic corporation that is regularly traded on an established securities market, if held by a person holding less than 5 percent of that class of stock.\(^5^5\) Section 1445 eliminates any withholding requirement even if the transfer is of stock held by a 5 percent shareholder.\(^5^6\) Because US’s stock is not publicly traded, this exception does not apply in the foreign controlled U.S. group contexts in any of the situations set forth above.

9. Foreign distributors. The gain rule for distributions by a foreign corporation under section 897(d)(1) is subject to an exception in section 897(d)(2) if the distributee would be subject to U.S. tax on the subsequent distribution or disposition of the property and has a carryover basis.\(^5^7\) Although one could argue in Situation 3 that this provision is satisfied because of the presumed status of US as a USRPHC, that argument could require that the taxpayer treat US as a USRPHC for the next five years. And even if the U.S. real property interest was subject to U.S. tax immediately after the exchange, there are timely filing requirements in temp. reg. section 1.897-5T(d)(1)(i)(ii) that must be satisfied\(^5^8\) that makes this exception inapplicable in our assumed facts.

10. Nonrecognition transactions. The exception in section 897(e)(1) for nonrecognition transactions\(^5^9\) also does not apply to our foreign controlled U.S. corporate group transactions. Section 897(e)(1) and temp. reg. section 1.897-6\(^6^0\) require that the interest being exchanged is a U.S. real property interest and the exchange is for an interest the sale of which is subject to U.S. tax.\(^6^1\) This requirement raises the same issues as the foreign distributor situation described above.\(^6^2\) If a nonrecognition provision does not apply to a transaction because it fails to meet the requirements of section 897(e) and temp. reg. section 1.897-6T, the gain realized from the transfer of the U.S. real property interest will be subject to U.S. tax under section 897.\(^6^3\)

Finally, it is interesting to note that Situation 4 is the fact pattern that led to the issuance of recent regulations under section 7874 that exempt from the inversion rules restructurings within a foreign controlled group. No similar exception has been provided under FIRPTA. In general, under section 7874, if a foreign corporation acquires directly or indirectly substantially all of the

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\(^{54}\)See letter from American Institute of Certified Public Accountants to Treasury and the IRS (June 2, 2008), following Notice 2006-99 and the retroactive withdrawal of reg. section 1.1441-1(b)(7)(iii), recommending to add to the priority list guidance on liability of a withholding agent for interest regarding withholding under section 1445 or section 1446, if the withholding agent does not withhold for a foreign person that has no U.S. tax liability, or that has satisfied its U.S. tax liability.

\(^{55}\)See reg. section 1.897-1(c)(2)(iii); see also reg. section 1.897-2(g)(3).

\(^{56}\)Reg. section 1.1445-2(c)(2).

\(^{57}\)Section 897(d)(2).

\(^{58}\)Temp. reg. section 1.897-5T(c)(2)(i)(C), adding to the statutory exception under section 897(d)(2)(A) that the distributing corporation must comply with the filing requirements.

\(^{59}\)For purposes of section 897(e) and temp. reg. section 1.897-6T, the term “nonrecognition provision” includes the following: (1) section 332; (2) section 351; (3) section 354; (4) section 355; (5) section 361; (6) section 721; (7) section 731; (8) section 1031; (9) section 1033; and (10) section 1036. Temp. reg. section 1.897-6T(a)(2).

\(^{60}\)See temp. reg. section 1.897-6T(b)(1), providing exception to the general rule for some foreign-to-foreign exchanges.

\(^{61}\)See temp. reg. section 1.897-6T(d)(1), providing rules for interests subject to taxation upon later disposition.

\(^{62}\)There are timely filing requirements for this exception set forth in temp. reg. section 1.897-5T(d)(1). Also, section 897(j) provides that gain inherent in contributions to capital is taxable unless exempted by regulations as well. Presumably this refers to contributions not otherwise covered by nonrecognition treatment.

\(^{63}\)Temp. reg. section 1.897-6T(a)(3).
assets of a domestic corporation and after the acquisition of a former shareholder or of the stock of a foreign corporation by reason of their ownership in the domestic corporation, then section 7874 treats the foreign corporation as a domestic corporation unless the foreign corporation has substantial business activities in the country in which it is incorporated compared with the substantial business activities of the expanded affiliated group (EAG), as defined in section 7874(c)(1), as a whole.

A special rule in section 7874(c)(2) provides that any stock owned by the EAG is excluded from both the numerator and denominator in determining the 80 percent ownership threshold. In our Situation 4, FP, US, and FS would all be part of the EAG. Accordingly, in determining the ownership threshold after the transfer by FP, the stock that FP owns in FS would be excluded from both the numerator and denominator, so that if there were any minority ownership in US that received stock in FS — no matter how small — the 80 percent ownership threshold would be triggered; moreover, even if there were no minority ownership as illustrated in Situation 4, the result would produce a fraction of 0/0, a result that is mathematically described as indeterminate or infinity, leading some to question even in a wholly owned fact pattern whether it was clear that the 80 percent ownership threshold had not been satisfied. Reg. section 1.7874-1, finalized in May 2008, provides relief from these rules in such intercompany restructurings by providing that FP’s stock ownership in FS is excluded from the numerator but not the denominator of the ownership fraction, thereby resulting in a fraction of 0/100.

D. Requests for Relief

Given the FIRPTA status presumption regarding domestic corporations, a transferor or transferee may realize after a distribution/disposition date that they failed to comply with section 897 and/or section 1445. Because the statement/notice procedure described in reg. sections 1.897-2(g)(1)(ii)(A), 1.897-2(h), 1.1445-2(c)(3)(i), 1.1445-2(d)(2), 1.1445-5(b)(2), and 1.1445-5(b)(4) all fall within the definition of a regulatory election, the taxpayer (which may be the transferor or the transferee) may request under reg. section 301.9100-1 and -3 an extension of time to file the statements and notices. This relief may be granted by the IRS if the taxpayer provides evidence that it acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government.

Since the enactment of the FIRPTA rules, there have been over 30 ruling requests granted for relief under reg. section 301.9100. While there were a few submissions in the 1990s, there were 21 submissions beginning in 2005. Although a few related to real USRPHCs, most dealt with cases in which the failure to follow the procedural requirements exposed the transaction to tax and the transferee to withholding tax liability, even though the domestic corporation was not a USRPHC under the substantive test of section 897(c)(2). Some of these rulings are illustrated below in the appendix to illustrate how easy it is to run afoul of the FIRPTA rules and the various situations in which the issue arises.

Finally, there is the practical problem of the scope of relief to request when the belated preparation of information regarding USRPHC status reveals there have been similar oversights in prior years, each of which could involve a preceding five-year period. The answer appears to lie in the general policy of the IRS not to enforce filing requirements for more than six years absent a history of noncompliance or other negative factors.


After several ruling requests for relief under reg. section 301.9100, the IRS responded on May 13, 2008, by issuing Rev. Proc. 2008-27, which provides a simplified method for taxpayers to request relief for late filings under reg. sections 1.897-2(g)(1)(ii)(A), 1.897-2(h), 1.1445-2(c)(3)(i), 1.1445-2(d)(2), 1.1445-5(b)(2), and 1.1445-5(b)(4). This procedure is in lieu of the letter ruling procedure that otherwise would be used under reg. section 301.9100, and it is applicable to all requests for relief received after June 26, 2008.

Unlike a ruling request under reg. section 301.9100, user fees do not apply to corrective action under Rev. Proc. 2008-27. A taxpayer can request relief under reg. section 301.9100 only if the taxpayer is denied relief by the IRS under Rev. Proc. 2008-27.

A taxpayer is eligible for relief from late filing of the statement/notice procedural requirements under Rev. Proc. 2008-27 on the same reasonable cause basis that applied for purposes of reg. section 301.9100. Once the taxpayer becomes aware of the failure to file the statements or notices, the taxpayer must file the completed statement and/or notice with the appropriate person and, if the statement/notice was filed after the due date, include a statement at the top of the documents that they are “Filed pursuant to Rev. Proc. 2008-27.” With a completed statement or notice required to be filed with the IRS, the taxpayer must attach an explanation describing why the failure to timely file the statement or notice was due to reasonable cause. And in the explanation, the taxpayer must state that it filed with, or obtained from, an appropriate person the appropriate statement or notice. The completed statement or notice attached to the explanation must be sent to the Ogden Service Center, P.O. Box 409101, Ogden, UT 84409.

Upon receipt of a completed application requesting relief, the IRS will determine whether the requirements for granting more time have been satisfied. The IRS will notify the taxpayer in writing within 120 days of the filing of the completed application only if it determines

64See reg. section 1.7874-1(f), Example 3.
65See reg. section 301.9100-1(b).
66See reg. section 301.9100-3(a).
that the failure to comply was not due to reasonable cause, or if more time will be needed to make a determination. If, once that period commences, the taxpayer is not again notified within 120 days, the taxpayer will be deemed to have established reasonable cause.

The implication of Rev. Proc. 2008-27 is that the National Office no longer wants to deal with ruling requests for relief under reg. section 301.9100 (the same information that would have been included in the ruling request regarding the failure and the reasonable cause is now merely shipped off to Ogden. The only change is that there will no longer be any transparency through the ruling publication process.

F. Recommendations

The foreign controlled circumstances that we have focused on here, in which the domestic corporation is clearly not a USRPHC, deserve a simplified process that eliminates the current regulation statement/notification procedures and the frequent need for Rev. Proc. 2008-27 (or reg. section 301.9100) relief. We recommend the IRS change the regulations to eliminate these requirements in the case of foreign controlled U.S. corporate groups. The regulations should replace the current mechanism with a presumption of FIRPTA tax liability in the case of covered dispositions, subject to rebuttal on audit. If the issue is not raised in an audit, the presumption should expire with the statute of limitations of the domestic corporation for the year of the covered distribution/disposition.

This recommendation has several advantages over the current process, without any additional compliance exposure for the IRS. It may even enhance compliance. It seems clear that foreign controlled groups that have dispositions involving U.S. subsidiaries that are in fact USRPHCs either recognize and report their tax liabilities or are eligible for a nonrecognition exception. The current statement/notification process is of no benefit to them. It merely presents an easily overlooked administrative hurdle in circumstances when the U.S. entity is not a USRPHC. On the other hand, reliance on a regular audit mechanism could increase the likelihood of identifying taxable transactions while providing the means for a careful review of exempt status.

Thus, permitting the presumption of liability to expire with the statute of limitations is unlikely to reduce tax collections. Audit practices should incorporate an automatic, pattern information document request to a foreign-owned U.S. corporate group regarding the existence of any potential FIRPTA distributions/dispositions, followed by requests for information necessary to determine the USRPHC status of the U.S. company if dispositions exist. The regulations should provide that disposition transactions create a rebuttable presumption of tax liability and require the U.S. subsidiary of the foreign group to rebut the presumption by providing information similar to the current statement within a reasonable, fixed period following a request during an audit.

These recommended changes for foreign controlled U.S. corporate groups would avoid many of the problems with the current compliance regime. The current statement/notification procedures are artificial in requiring controlled parties to report to one another, and these requirements are easily and understandably overlooked by foreign owners conducting internal group restructurings. They deserve relief similar to that granted to foreign controlled groups in the context of the inversion rules under section 7874. Our recommended procedures would acknowledge that the statement/notification process is artificial in this context and would leave the determinations to the audit. The existence of the rebuttable presumption would provide the IRS with all of the enforcement leverage it requires in these circumstances.

The recommendations also have the advantage of eliminating prospects for the body of private law that may arise under the silence-is-approval policy of the revenue procedure, while eliminating the administrative drain that is necessarily involved in these requests. Moreover, it is not clear under what circumstances a taxpayer would not have reasonable cause for failing to follow the statement/notification procedures. We assume that if there have been unsuccessful requests for relief under reg. section 301.9100 in this area, they were withdrawn before the public benefited from the publication of a negative private letter ruling. Nevertheless, the IRS's discretion to find that reasonable cause for the compliance failure existed presents the potential for abuse. The authors are aware of at least one circumstance in which relief under reg. section 301.9100 was withheld until the taxpayer made additional concessions on issues related to the transaction that triggered the potential FIRPTA liability. This seems an improper exercise of discretion under reg. section 301.9100.

Reporting requirements do not appear to be a suitable alternative. Congress has already attempted two reporting regimes regarding the FIRPTA rules. The Omnibus Reconciliation Act of 1980 added section 6039C to the code in conjunction with section 897. That provision required domestic corporations to file a return if it was a USRPHC under section 897(c)(2) listing all of its foreign shareholders and any transfers of its stock. Congress introduced the section 1445 withholding regime in 1984 in part because the IRS had delayed the regulations under section 6039C, but at the same time Congress revised section 6039C.

As revised, to the extent provided in regulations, the reporting requirement now falls on any foreign person that owns “direct investments in United States real property interests.” While the use of the word “direct” might appear at first blush to exclude stock interests in domestic corporations, the definition in section 6039C(c) incorporates section 897(c) and thus the rule that any interest in domestic corporation stock is a U.S. real property interest. Fortunately, no regulations have been issued under this provision, so there is currently no reporting requirement.

Appendix

A. Illustrations of Relief

For presentation purposes, any shaded square represents a domestic corporation. Indirect ownership is noted by a slash mark on the connecting lines between the
corporations. For simplicity, the defined terms for the parties used in our illustrations may not correspond with the terminology used in the private letter rulings.

Unless otherwise noted, the domestic corporations in the private letter rulings were not USRPHCs under the substantive test of section 897(c)(2), but the statement/notice procedural requirements discussed in this article were not followed.

1. Redemption of stock. In LTR 200840014 (June 20, 2008), Doc 2008-21269, 2008 TNT 194-47, domestic parent (US), a nonpublicly traded corporation, owned all the stock of a foreign corporation (FS). FS owned shares in US, and US redeemed the shares held by FS for a note. The redemption of shares of a domestic corporation under section 302 is a disposition for purposes of section 897(a), as shown in Figure 5.69

2. Section 351 transactions. In LTR 200838007 (June 13, 2008), Doc 2008-20069, 2008 TNT 184-18, a foreign corporation (FP) wholly owned two domestic corporations (US 1 and US 2). In a section 351 transaction, FP contributed its shares of US 2 to US 1 in exchange for one share of US 1 and a note.

Even though section 351 is a nonrecognition provision, the contribution is subject to section 897(a), a variation of Situation 4, because section 897(e) was inapplicable where FP received in the exchange stock in another domestic corporation (US 1), which was not a U.S. real property interest under the substantive test of section 897(c)(2).

Afterwards, at a time when US 1 had no current or accumulated E&P, US 1 distributed cash to FP in a section 301 transaction. Section 301 distributions in excess of E&P are subject to section 897(a) and section 1445(e)(3), similar to Situation 1. (See Figure 6.)

In LTR 200831007 (Apr. 20, 2008), Doc 2008-16884, 2008 TNT 150-32, a foreign corporation (FP), through a disregarded entity (DE), owned all of a domestic corporation (US 1) and two foreign corporations (FS 1 and FS 2). US 1 in turn owned all of a domestic corporation (US 2). (See Figure 7.)

DE transferred all its interests in US 1 and FS 2 to FS 1. The contribution was intended to qualify under section 351, a variation of Situation 4.70 Section 897(a) was applicable to the contribution because a U.S. real property interest was not received in the exchange (that is, section 897(e) was inapplicable where DE received stock of a foreign corporation). Afterwards, FS 1 transferred its entire interest in US 1 to FS 2, similar to Situation 4. Although it was a section 351 transaction, section 897(a) was applicable to the contribution because stock in FS 2, a foreign corporation, is not a U.S. real property interest (that is, section 897(e) was inapplicable). Figure 8 depicts the structure after the contributions.

To effectuate an internal restructuring, LTR 200726028 (Mar. 23, 2007), Doc 2004-15270, 2004 TNT 127-21, represents a case in which the FIRPTA rules were violated in

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69The ruling request dealt only with the section 897 liability. The transaction would also have been subject to section 1445(6)(3) (distributions by domestic corporations to foreign shareholders) and the requirements under reg. section 1.1445-5(6)(3).

70The ruling request dealt only with the section 897 liability.
consecutive section 351 transfers of the same domestic corporation stock (similar to Situation 4). Section 897(e) was inapplicable to the section 351 transactions because a U.S. real property interest was not received in the exchanges (either stock in another foreign corporation or a domestic corporation that was not a U.S. real property interest under the substantive test of section 897(c)(2) was received). (See Figure 9.)

LTR 200631020 (May 4, 2006), Doc 2006-15210, 2006 TNT 156-26, involved three types of transactions. First, a foreign subsidiary (FS 1) transferred all of the stock of a domestic corporation (US 1) to its parent (FP) in exchange for cancellation of debt by FP. Such a disposition is subject to section 897(a) and section 1445. Second, FP transferred all of the stock of US 1 to its foreign subsidiary (FS 2), and then FS 2 transferred that US 1 stock to another foreign corporation (FS 3) (similar to Situation 4). Although they were section 351 transactions, both transfers were subject to section 897(a) and section 1445. Lastly, FS 1 sold stock of a domestic corporation (US 2) to FS 3 in a taxable transaction, clearly subject to section 897(a) and section 1445. Figure 10 shows the structure before the transaction.

The final structure is shown in Figure 11.
B. Liquidations and Entity Classification

In LTR 200735004 (June 4, 2007), Doc 2007-20133, 2007 TNT 171-40, a foreign corporation (FP) owned all of the stock of a foreign corporation (FS), which in turn owned all of the stock of a domestic corporation (US). FS liquidated into FP, a variation of Situation 3, in a liquidation under section 332. Section 897(d) is applicable to liquidating distributions and provides that gain will be recognized for section 897(a) purposes. The exception in section 897(d)(2) was inapplicable where FP would not be subject to tax on the subsequent distribution of US (which under the substantive test is not a U.S. real property interest). (See Figure 12.)

LTR 200634014 (May 17, 2006), Doc 2006-16254, 2006 TNT 167-78, had the same fact pattern — the liquidation of a foreign subsidiary (FS), which owned all of the stock of a domestic corporation (US), into its foreign parent (FP). Again, section 897(d) was applicable and the exception in section 897(d)(2) was inapplicable.

In LTR 200609017 (Nov. 28, 2005), Doc 2006-4157, 2006 TNT 43-37, a foreign corporation (FP) owned all of a domestic corporation (US). Corp C, which was unrelated to FP or US before the transactions at issue, owned all of the stock of a foreign corporation (FS). (See Figure 13.)

Corp C transferred all of its stock in FS to US in exchange for US stock. FS then converted from an Italian S.p.A. (Società per azioni) to an S.r.l. (Società a responsabilità limitata), an eligible entity, and checked the box to be disregarded for federal income tax purposes, which is treated as a deemed liquidation of FS (similar to Situation 3). This was in the event that relief under reg. section 301.9100 was granted. While not specifically addressed in the ruling, it appears that the check-the-box election by FS (which was followed by the liquidation of Corp C) was treated as a reorganization under section 368(a)(1)(D). As a result, FS received stock of US in the reorganization and thus was a disposition subject to section 897.

Both LTR 200409013 (Nov. 17, 2003), Doc 2004-3943, 2004 TNT 40-56, and LTR 200304022 (Oct. 23, 2002), Doc 2003-2222, 2003 TNT 17-27, involved the same fact pattern: A foreign corporation (FP) owned all of a foreign subsidiary (FS), and FS owned all the stock of a domestic corporation (US). FS checked the box to be disregarded for federal income tax purposes, which is treated as a deemed liquidation of FS (similar to Situation 3). Section 897(d)(1) was applicable to the deemed liquidation. (See Figure 14.)

C. Intended Reorganizations

In LTR 200714014 (Apr. 6, 2007), Doc 2007-8964, 2007 TNT 68-35, to simplify the U.S. ownership structure, a domestic corporation (US 1) merged into another domestic corporation (US 2). As a result, foreign corporation (FP), though a disregarded entity (DE), exchanged its US 1 stock for US 2 stock. This is a disposition for purposes of section 897, and section 897(e)(1) was inapplicable. US 2 was not a U.S. real property interest under the substantive test of section 897(c)(2). (See Figure 15.)

LTR 199942024 (July 27, 1999), Doc 1999-34304, 1999 TNT 205-37, involved a reorganization under section 368(a)(1)(F) of a domestic corporation (US) that was wholly owned by a foreign corporation (FP). In the reorganization, stock of US was exchanged for stock of New US. Even though section 354(a)(1) provides nonrecognition to the shareholder FP, section 897 was applicable because a subsequent disposition of New US would not be subject to taxation. (See Figure 16.)

D. Nine Restructuring Transactions

LTR 200742008 (July 5, 2007), Doc 2007-23410, 2007 TNT 204-34, involved nine separate transactions that crossed several tax years. All transactions were solely within the group of corporations owned by foreign parent (FP) and involved internal restructuring.

1. Transaction 1. A foreign corporation (FS Entity 1), which was a subsidiary of FP, sold its entire interest in a domestic corporation (US Entity 2) to an entity (DE Entity
3. For federal tax purposes, DE Entity 3 was classified as a disregarded entity of a foreign partnership (F Partnership Entity 4). The partners of F Partnership Entity 4 were two foreign corporations within FP’s then existing group. FS Entity 1’s sale of its interest in US Entity 2 was a disposition for purposes of section 897(a), and gain was realized under section 1001. (See Figure 17.)

When the ruling request was submitted, US Entity 2 was no longer in existence and through reorganizations is now part of US Entity 6, a domestic corporation. (See Transaction 5 discussed below.)

2. Transaction 2. A foreign corporation (FS Entity 7) converted under foreign law from an entity classified as a per se corporation for federal tax purposes to an entity classified as an eligible entity for federal tax purposes. FS Entity 7 also changed its name and elected under reg. section 301.7701-3 to be treated for federal tax purposes as an entity disregarded from its owner, a foreign corporation (FS Entity 8). At the time of the election, FS Entity 8 owned all the stock of a domestic corporation (US Entity 6). The election to be a disregarded entity for U.S. tax purposes is treated as a deemed liquidation of FS Entity 7. The constructive section 332 liquidation was subject to gain recognition under section 897(d) and, similarly, section 1445(e)(2) and reg. section 1.1445-5(d) (similar to Situation 3). (See Figure 18.)

3. Transaction 3. FS Entity 8 converted under foreign law to an entity classified as a per se corporation for purposes of reg. section 301.7701-2(b)(8) in a transaction intended to qualify under section 368(a)(1)(F). At that time, FS Entity 8, through its disregarded entity (FS Entity 7), owned the stock of a domestic corporation (US Entity 6). For U.S. tax purposes, FS Entity 8 is treated as exchanging its assets, including its stock in US Entity 6, for stock of New FS Entity 8. This deemed asset transfer was a disposition for purposes of section 897, and in the disposition, FS Entity 8 realized gain under section 1001. (See Figure 19.)
4. **Transaction 4.** DE Entity 3, which was a disregarded entity of a foreign partnership (FP Partnership Entity 4), contributed assets that included stock of a domestic corporation (US Entity 2) to a foreign corporation (FS Entity 8) in exchange for voting and nonvoting stock of FS Entity 8, which is not a U.S. real property interest, and cash. The partners of FP Partnership Entity 4 were two foreign corporations within FP’s then existing group. In the contribution, gain was realized under section 1001 and is therefore subject to section 897(a). (See Figure 20.)

5. **Transaction 5.** US Entity 2, a domestic corporation, statutorily merged into a domestic corporation (US Entity 11), which was the predecessor to US Entity 6. US Entity 11 later changed its name to US Entity 6. Before the merger, a foreign corporation (FS Entity 8) was the sole shareholder of US Entity 2 and US Entity 11. At that time, FS Entity 8 owned stock of other domestic corporations. For simplicity, only the domestic corporations at issue are shown in the diagrams. FS Entity 8 received US Entity 11 stock and the right to deferred cash payments in exchange for its US Entity 2 stock. This exchange was a realization event under section 1001.72 (See Figure 21.)

6. **Transaction 6.** A foreign corporation (FS Entity 8) made a distribution of the stock of two domestic corporations (US Entity 6 and US Entity 12) to its sole shareholder, a foreign corporation (FS Entity 13, a variation of Situation 2). FS Entity 13 is now known as FS Entity 14. (See Transaction 7 below.) The distribution of stock in a domestic corporation by a foreign corporation to another foreign corporation was subject to gain recognition under section 897(d). (See Figure 22.)

7. **Transaction 7.** A foreign corporation (FS Entity 13) changed its place of incorporation from one foreign country to another foreign country and changed its name to FS Entity 14. At the time of reincorporation and name change, FS Entity 13 owned all the stock of US Entity 6 and US Entity 12,73 both domestic corporations. This transaction was likely a reorganization under section 368(a)(1)(F), in which FS Entity 13 is treated as distributing all of its assets to New FS Entity 13 (FS Entity 14). This deemed asset transfer was a disposition, and in the disposition, FS Entity 13 realized gain under section 1001. (See Figure 23.)

8. **Transaction 8.** A foreign corporation (FS Entity 14) distributed all the stock of US Entity 6 and US Entity 12, both domestic corporations, to its sole shareholder, a

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71US Entity 2 no longer exists and through reorganizations is now part of US Entity 6. (See Transaction 5 discussed below.)

72The taxpayer did not request section 1445 relief for this transaction given that the transferee did not “acquire” a U.S. real property interest; section 1445 does not appear to be applicable to this transaction. See reg. section 1.1445-2(a); reg. section 1.1445-5(e).

73US Entity 12 was liquidated into FS Entity 15 after the transaction.
The distribution of stock in a domestic corporation by a foreign corporation to another foreign corporation was subject to gain recognition under section 897(d). (See Figure 24.)

9. **Transaction 9.** A foreign corporation (FS Entity 16) sold all the stock of US Entity 12,74 a domestic corporation, to a foreign corporation (FS Entity 15). At the time of the sale, FS Entity 16 was an indirect subsidiary of FS Entity 15. The sale was a disposition under section 897(a) and gain was realized under section 1001. (See Figure 25.)

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74US Entity 12 was liquidated into FS Entity 15 after the transaction.
Incorporating the Tax Expenditure Concept Into the Tax Code

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Emil M. Sunley reviewed and provided important comments and advice to this article. The author also thanks Weizhen Li for her research assistance. Any errors are the responsibility of the author.

A. Introduction

Under section 3(a)(3) of the Congressional Budget Act of 1974,1 tax expenditures are defined as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of tax liability.” In that same act, a tax expenditure budget is defined as “an enumeration of such tax expenditures.”

The concept of tax expenditures was first introduced by Stanley Surrey in 1967 for the purpose of distinguishing between two totally different roles of tax provisions in the Internal Revenue Code, namely, tax structure provisions and tax expenditure provisions. As Surrey described it:

The federal income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures. This second system is grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation. Instead, the system of tax expenditures provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies.2

Since it was introduced by the Budget Act of 1974, tax expenditure budgeting has never reached its full potential as an analytical tool designed to achieve the two main goals that inspired its proponents: clarifying the aggregate as an analytical tool designed to achieve the two main goals and improving the code.3 Several essential factors con- tribute to the ineffectiveness of tax expenditure analysis — for example, the disagreements about the definition of a normal tax benchmark based on which tax expendi-

1P.L. 93-344.
3Joint Committee on Taxation, “A Reconsideration of Tax Expenditure Analysis” (JCX-37-08), May 12, 2008, p. 1.

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Tax-induced structural distortions are defined as an expanded concept of tax expenditures that is broader than the narrow concept of tax subsidies. Tax-induced structural distortions are those tax provisions that are structural elements of the code and that materially affect economic decisions in a manner that imposes substantial economic efficiency costs.

Examples of tax-induced structural distortions include deferral treatment of foreign earnings and the differential taxation of debt and equity.

The JCT’s classification of tax expenditures aims to facilitate tax policy analysis regarding equity, efficiency, and ease of administration.

The JCT’s new approach is generally consistent with international practice, using general taxation rules to classify tax provisions as tax expenditures. This system is used in many countries around the world, including Australia, Belgium, the Netherlands, and Turkey. These countries use general rules of taxation to establish tax benchmarks and to identify the deviations from those benchmarks as tax expenditures.

The JCT’s new approach has solved the foundational controversy regarding the “normal tax system” concept. The JCT’s approach now provides the opportunity to incorporate the concept of tax expenditures into the code, and to improve estimates of revenues forgone and the analysis of the effects of tax expenditures on federal budget.

C. The Concept of Tax Expenditures and the Code

The Budget Act of 1974 recognizes that tax expenditure provisions are special provisions that result in revenue losses, thus characterizing their particular role in taxation as the opposite of the roles of tax structural provisions, which are necessary to implement individual and corporate income taxes.

This tax expenditure concept recognizes that a tax system contains two components that are conceptually and functionally distinct in, although interwoven into, the tax law. One component contains those provisions necessary to implement the structural function of taxation. The other contains tax expenditure provisions to implement government spending programs.

However, this recognition of the concept of tax expenditures and the role of tax expenditure provisions in the tax system has not been incorporated into the code. Even today, the code does not distinguish between structural provisions and tax expenditure provisions.

Historically, this can be traced back to at least the 1939 version of code, which had only one type of tax provision. Although the concept of tax expenditure provisions was written into the Budget Act of 1974, and the two types of tax provisions play distinctive roles in taxation, the code has not been updated in this respect since 1974.

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7See id. at p. 9 and p. 20. P.L. 93-344, section 3(3)(3) currently codified to 2 U.S.C. 622.3.


As a result, taxpayers often understand tax provisions only in the broad sense and do not recognize the difference between tax structural provisions and tax expenditure provisions. Also, it is difficult to analyze the different effects of the two types of provisions on taxation and on the federal budget.

D. A Proposal

To improve the analysis of tax structure and the effects of tax expenditures on federal budgets, as well as to improve tax code transparency, the code should incorporate the concept of tax expenditures. This proposal discusses incorporating the concept of tax expenditures into the code and estimates the amount of revenue forgone when the code is updated.

1. Incorporating the concept of tax expenditure provisions into the code. This article proposes incorporating the concept of the tax expenditure provision into the code by defining tax structural provisions and tax expenditure provisions.

The clarity of the code might be improved by grouping chapters dealing with tax expenditures together. Also, the computation of taxable income has to be adjusted accordingly to distinguish between tax structure provisions and tax expenditure provisions. This will involve five necessary changes to the code, including adjusting the definition of gross income, creating two new concepts (structural taxable income and structural tax interim liability), and adjusting the definition of taxable income. The five changes are presented in the following formulas:

(1) Gross income = income - tax structural exclusions;
(2) Structural taxable income = gross income - tax structural provisions (for example, deductions and exemptions); and
(3) Structural tax interim liability can then be calculated based on the tax rate schedules (structural rates) using structural taxable income.

Taxable income, then, is defined as structural taxable income minus tax expenditure provisions:
(4) Taxable income = structural taxable income - tax expenditure provisions.

Here, tax expenditure provisions include all special exclusions, exemptions, or deductions identified by the JCT’s approach.

The amount of taxable income, after whatever adjustments have been made above, should be the same amount as that computed under the current provisions of the code.

(5) Tax liability can be calculated based on the taxable income and applicable tax rate schedules, allowed tax credits, and deferral of tax liabilities, as determined by the code.

The amount of tax liabilities should also be the same as those under current provisions of the code.

2. Estimates of forgone tax revenue and adjustment factors. If the concepts of structural taxable income and structural tax interim liability were introduced in the code, forgone tax revenue would be estimated as tax liability minus structural tax interim liability.

As usual, forgone revenue is estimated by applying individual tax expenditure provisions separately, assuming all other factors remain unchanged. The difference between tax liability and the structural tax interim liability is the revenue forgone because of the application of this tax expenditure provision.

In a progressive income tax rate structure, the combined effect of claiming several tax expenditure provisions may move a taxpayer to a lower tax bracket than would have been applicable had none of the tax expenditure provisions existed.

For example, consider a taxpayer that has structural taxable income of $79,500 and is in the 28 percent tax bracket, and assume that the structural tax interim liability is $16,370.75.

Imagine the taxpayer took two tax deductions, $12,000 for mortgage interest and $2,500 for a regular IRA. Applying the mortgage interest deduction would reduce her taxable income and later her federal tax liability by $3,072. Applying her IRA deduction would reduce her taxable income and later her tax liability by $697. Applying both measures simultaneously, however, would reduce her taxable income and later her tax liability by $3,697. This is less than the sum ($3,769) of the reductions in tax liability that result from each of these deductions computed separately (see Table 1).

This difference is caused by interactive effects after applying the two tax expenditure provisions, either separately or simultaneously, that drop the taxpayer’s taxable income into a tax rate bracket that is different from the one applicable to her structural taxable income.

Because of the interactive effects, the total revenue forgone by a group of tax expenditures (calculated individually) often differ from the dollar value of the revenue forgone calculated by applying the same group of tax expenditures at the same time.

To solve the interactive effects problem, this article proposes to use factors to adjust the estimates of forgone revenue, which are calculated by applying tax expenditure provisions separately.

The process of deriving the formulas of adjustment factors and estimates of adjusted forgone individual tax revenue (by applying each individual tax expenditure provision separately) are presented in the appendix. The proposed adjustment factors and estimates of adjusted forgone individual tax revenue apply to three types of cases.

Case One. When each individual tax expenditure provision is applied separately, the reduced taxable income stays in the same marginal tax rate bracket as structural taxable income. However, when all tax expenditure provisions are applied simultaneously, the reduced taxable income drops into the next lower bracket.

Case Two. When each tax expenditure provision is applied separately, the reduced taxable income drops into the next lower marginal tax rate bracket. Also, when all tax expenditure provisions are applied simultaneously, the reduced taxable income drops into the next lower bracket.

Case Three. When some individual tax expenditure provisions are applied separately, the reduced taxable
income stays in the same marginal tax rate bracket as structural taxable income. However, when other individual tax expenditure provisions are applied separately, the reduced taxable income drops into the next lower marginal tax rate bracket. Also, when all tax expenditure provisions are applied simultaneously, the reduced taxable income drops into the next lower bracket.

Here, the assumption will be that structural taxable income is $Y_0$ which has an applicable marginal rate T_0 and is more than the amount of $\alpha_0$, and the structural tax interim liability, y_0.

When applying the individual tax expenditure provision, $x_i$ (i = 1...n), separately, the reduced taxable income is $Y_i$ (i = 1...n), whose applicable marginal rate bracket is $T_i$ (i = 1...n), which is over the amount of $\alpha_i$ (i = 1...n); the corresponding tax liability is $y_i$ (i = 1...n).

When applying all tax expenditure provisions together, $\sum x_i$, the reduced taxable income is $Y_e$, whose applicable marginal tax rate bracket is $T_e$, which is more than the amount of $\alpha_e$; the corresponding tax liability is $y_e$.

The relationship of $Y_i$, $T_i$, $y_i$, and $\alpha_i$ (i = 1...n) is shown in the 2007 tax rate schedules below.

The adjustment factor is presented as $\lambda$, and the adjusted individual tax revenue forgone is presented as $\Delta y_i$. The formulas for these are listed below, and are derived in the Appendix. The tax rate schedule table is below.

In Case One, because of $T_i=T_0$, the formulas can be derived as follows:

$$\lambda = \frac{1}{n} (Y_0 - \alpha_0)^* (T_e - T_0) \cdot \frac{1}{n} \sum x_i^* (T_e - T_0)$$  \hspace{1cm} (A1)

$$\Delta y_i = - x_i^* T_0 + \left[ \frac{1}{n} (Y_0 - \alpha_0)^* - \tau \right] (T_e - T_0); \hspace{0.5cm} i = 1, \ldots, n.$$

In Case Two, because of $T_i=T_e$, the formulas can be derived as follows:

$$\lambda = \frac{n-1}{n} (Y_0 - \alpha_0)^* (T_0 - T_e)$$  \hspace{1cm} (A2)

$$\Delta y_i = - x_i^* T_e \cdot \frac{1}{n} (Y_0 - \alpha_0)^* (T_0 - T_e); \hspace{0.5cm} i = 1, \ldots, n,$$

In Case Three, the formulas for the adjustment factor can be derived as follows:

$$\lambda = \frac{n-j}{n} (Y_0 - \alpha_0)^* (T_0 - T_e) + \frac{1}{n} \sum_{j=1}^{i-1} x_i^*(T_0 - T_e)$$  \hspace{1cm} (A3)

So that when $i = 1, \ldots, j-1,$

$$\Delta y_i = \frac{n-j}{n} (Y_0 - \alpha_0)^* (T_0 - T_e) + \frac{j-1}{n} \sum_{j=1}^{i-1} x_i^* (T_0 - T_e) - x_i^* T_0$$  \hspace{1cm} (B3)

And when $i = j, \ldots, n$

$$\Delta y_i = \frac{j}{n} (Y_0 - \alpha_0)^* (T_0 - T_e) + \frac{j-1}{n} \sum_{j=1}^{i-1} x_i^* (T_0 - T_e) - x_i^* T_0$$  \hspace{1cm} (B4)

In the appendix, it is demonstrated that by using adjustment factors to adjust forgone individual tax revenue estimated by applying tax expenditure provisions separately, interactive effects can be corrected.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Marginal Tax Rate</th>
<th>Tax Liabilities*</th>
<th>Revenue Foregone</th>
</tr>
</thead>
<tbody>
<tr>
<td>$79,500</td>
<td>0.28</td>
<td>$16,370.75</td>
<td></td>
</tr>
</tbody>
</table>

A. Applying individual deduction separately

(1) Mortgage interest

($12,000) $79,500 0.28 $16,370.75

(2) Contribution to IRA

($2,500) 77,000 0.25 15,673.75 -697

Total

-3,769

B. Applying both deductions (1) and (2) together

($12,000 + $2,500) 65,000 0.25 12,673.75 -3,697

Interactive effects (Difference between (B) and the total in (A))

-72
As a result, the sum of the adjusted individual revenue forgone (estimated by applying individual tax expenditure provisions separately) would be equal to the forgone revenue that is estimated by applying all tax expenditure provisions simultaneously.

Therefore, the adjusted forgone revenue can be summed up. A group of tax expenditure provisions, or all tax expenditure provisions, can be aggregated. The total of forgone revenue can now be estimated and used much more effectively in the overall budget analysis.

E. Conclusion

Tax expenditures are an important fiscal policy measure. In the United States, total tax expenditures are growing, and almost approach the amount of discretionary and non-interest mandatory spending. In particular, in the FY2008 budget, Treasury listed a total of $987 billion in tax expenditures for FY2008. This total approaches the total amount of discretionary spending ($1,114 billion in FY2008) and noninterest mandatory spending ($1,527 billion in FY2008).10

Both the Government Accountability Office and the Congressional Budget Office have urged a restoration of the statutory budget controls — including meaningful caps on discretionary spending and “pay as you go” budget rules on both the tax and spending sides of the ledger.11 To make “pay as you go” effective on the tax side, it is critical to manage tax expenditures in the same way as managing outlays in the budget, in order to achieve fiscal accountability and transparency.

Hence, it is critically important to effectively implement the legislative decision of the Congressional Budget Act of 1974 regarding the definition of tax expenditures, to incorporate the new approach proposed by JCT to classify tax provisions as tax expenditures, and to incorporate the concept of tax expenditures into the code, paving a pathway to build a budget system which is able to effectively manage spending and ensure fiscal accountability on both the tax and outlays sides of the ledger. In addition, it is also important to implement meaningful methods for estimating tax expenditures. The adjustment factors described in this article would be useful for this purpose.

Adjustment factors are commonly used in economic statistics for making necessary and meaningful corrections in statistical measurements when facing economic uncertainty. The adjustment factors in this article exhibit only one type of adjustment: the simple average adjustment factor.

If necessary, other kinds of adjustment factors can also be formulated — for example, weighted average adjustment factors. The principles for formulating adjustment factors for tax expenditure estimates are basically the same. It should be decided in advance what kind of adjustment factor is most suitable when adjusting tax expenditure estimates.

For example, suppose we present a tax expenditure budget (with all of the adjustment factors), but Congress wants to repeal only the deduction for mortgage interest. The simple average adjustment factor could underestimate the revenue gain. With this in mind, we may decide in advance to use the weighted average adjustment factor by adding proper weights in the formulas in calculating adjustment factors. However, this article does not expand the discussion on weighted average adjustment factors, but instead leaves it to the readers to explore.

More importantly, by incorporating the concept of tax expenditures into the code, introducing the new definition of gross income and concepts of structural taxable income and structural tax interim liability, and using adjustment factors in estimating forgone revenue, it becomes possible to link together three factors: the structural tax interim liabilities, forgone tax revenues, and tax revenue actually received. This can be shown as follows:

Structural Tax Interim Liability - Forgone Tax Revenue = Tax Revenue Received

This relationship among structural tax interim liabilities, forgone tax revenue, and tax revenue received would further confirm the concept of tax expenditures — namely, that tax expenditures are “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of tax liability.”

This relationship also confirms that tax expenditure provisions are government spending channeled through the tax system, and that the true size of government should be the sum of direct expenditures and tax revenue forgone.

By using these techniques, the effectiveness of budget management and control, as well as fiscal accountability and transparency of both the tax and the outlays sides of the budget, can be greatly improved.

Appendix

1. Adjustment factors for correcting interactive effects in estimates of forgone revenue. Interactive effects are one of the major problems in estimating forgone tax revenue. Because of interactive effects, the sum of the amount of forgone tax revenue (as estimated by applying individual tax expenditure provisions separately) often does not equal the amount of forgone tax revenue, as estimated by applying all tax expenditure provisions simultaneously. As a result, the estimates of forgone tax revenue cannot be summed up; therefore, the total impact of tax expenditure provisions cannot be meaningfully assessed.

This analysis introduces adjustment factors that will be used to adjust the amount of individual revenue forgone (as estimated by applying tax expenditure provisions separately) and to correct the interactive effects,
Thus making the sum of those estimates equal to the revenue foregone. Using the estimates of adjusted forgone revenue, we are able to calculate the sum of a group of tax expenditures, or of all tax expenditure provisions, for policymaking purposes.

The adjustment factors introduced in this analysis would be used for three circumstances common in estimating forgone revenue. The core situations are those in which, as a result of separate application of individual tax expenditure provisions, the reduced taxable income will either stay at the same marginal tax rate bracket as the structural taxable income, or drop into the next lower bracket. In either event, the reduced taxable income, when all tax expenditure provisions are applied simultaneously, will be in the next lower bracket as the structural taxable income.

Many other adjustment factors can be generated by following the method used in this article to deal with other special situations not commonly found in the taxation process. For example, one situation is that the reduced taxable income (as calculated by applying individual tax expenditure provisions separately) drops into the next lower bracket. However, this bracket is not the same bracket applicable to the reduced taxable income, as calculated by applying all tax expenditure provisions simultaneously.

In this analysis, we used Case One, Case Two, and Case Three, referred to in Section D.2.

For purposes of this analysis, the IRS’s 2007 tax rate schedules will be used.

a. Case One. In Case One, the assumption is that the structural taxable income is \(Y_s\) in the 28 percent marginal tax rate bracket \(t_s\), and structural tax interim liability is \(y_0\). When applying the individual tax expenditure provisions, \(x_i\) (\(i = 1, \ldots, n\)), the reduced taxable income is \(Y_i\) (\(i = 1, \ldots, n\)), which stays in the 28 percent marginal rate bracket, and the reduced tax liability is \(y_i\) (\(i = 1, \ldots, n\)). When applying all tax expenditure provisions simultaneously, \(\Sigma x_i\), the reduced taxable income is \(Y_e\), which drops into the 25 percent marginal rate bracket \(t_e\).

Here, \(Y_i = Y_s x_i\), \(i = 1, \ldots, n\); and \(Y_e = Y_s \Sigma x_i\), \(i = 1, \ldots, n\).

The forgone revenue (as estimated by applying individual tax expenditure provisions separately) is presented as \(\Delta y_i\). The forgone revenue as estimated using all tax expenditure provisions simultaneously is presented as \(\Delta y_e\).

Here, \(\Delta y_i = y_i - y_0\) and \(\Delta y_e = y_e - y_0\).

Using the above information, the formula for estimating forgone individual revenue by applying each tax expenditure provision separately can be derived as:

\[
\Delta y_i = 15,698.75 + (Y_i - 77,100)\cdot 28\% - [15,698.75 + (Y_s - 77,100)\cdot 28\%]
\]

\[
= 15,698.75 + [Y_s - 77,100 - x_i]\cdot 28\% - [15,698.75 + (Y_s - 77,100)\cdot 28\%]
\]

\[
= (Y_e - 77,100)\cdot 28\% - x_i\cdot 28\% - (Y_e - 77,100)\cdot 28\%
\]

\[
=-x_i\cdot 28\%; \quad i = 1, \ldots, n
\]

Then, the sum of above is:

\[
\Sigma \Delta y_i = -\Sigma x_i\cdot 28 (1)
\]

The formula for forgone revenue, as estimated by applying all tax expenditure provisions simultaneously, can be derived as:

\[
\Delta y_e = 4,386.25 + (Y_e - 31,850)\cdot 25\% - [15,698.75 + (Y_s - 77,100)\cdot 28\%]
\]

\[
= 4,386.25 + (Y_e - \Sigma x_i - 31,850)\cdot 25\% - [15,698.75 + (Y_s - 77,100)\cdot 28\%]
\]

\[
= (Y_e - 77,100)\cdot (25\% - 28\%) - \Sigma x_i\cdot 25\% (2)
\]

Thus, the formula for the sum of interactive effect can be derived as the difference between \(\Delta y_e\) and \(\Sigma \Delta y_i\), using formulas (1) and (2):

\[
\Delta y_e - \Sigma \Delta y_i = (Y_e - 77,100)\cdot (25\% - 28\%) - \Sigma x_i\cdot (25\% - 28\%)
\]

To resolve the interactive effect, \(\Delta y_i (i = 1, \ldots, n)\) has to be adjusted. The adjustment factor \((i)\) can be derived, with \(n\) tax expenditure provisions, from formula (3), as follows:

\[
\lambda = \frac{1}{n} [(Y_e - 77,100)\cdot (25\% - 28\%) - \Sigma x_i\cdot (25\% - 28\%)]
\]

\[
= \frac{1}{n} (Y_e - 77,100)\cdot (25\% - 28\%) - \frac{1}{n} \Sigma x_i\cdot (25\% - 28\%)
\]
After rearranging
\[ \lambda = \left[ \frac{1}{n} \sum_{i=1}^{n} (Y_i - 77,100) \right] - \tau \] *(25%-28%)
(4)

Here, \( \tau = \frac{1}{n} \sum_{i=1}^{n} x_i \).

To adjust \( \Delta y_i \) by adding \( \lambda \) to \( \Delta y_i \), the formula for adjusted forgone revenue \( \Delta y_i \) is as follows:
\[ \Delta y_i = -x_i \times 28\% + \left[ \frac{1}{n} \sum_{i=1}^{n} (Y_i - 77,100) \right] - \tau \] *(25%-28%); \( i = 1, \ldots, n \) (5)

Now, to examine the interactive effects, we can calculate the difference between \( \Delta y_e \) and the sum of the estimates of adjusted forgone revenue, \( \Delta y_i \).
\[ \Delta y_e - \sum_{i=1}^{n} \Delta y_i = \left[ \frac{1}{n} \sum_{i=1}^{n} (Y_i - 77,100) \right] - \tau \] *(25%-28%)
\[ = 0 \]

As a result, the interactive effects do not exist when using adjusted \( \Delta y_i \) by adding the adjustment factor \( \lambda \) to \( \Delta y_i \); \( i = 1, \ldots, n \).

Therefore, using adjusted forgone revenue, the sum of forgone individual revenue estimated separately equals the forgone revenue estimated by applying all tax expenditure provisions simultaneously.

Table 2 above gives an example.
\( \tau \) and \( \lambda \) can be calculated as:
\[ \tau = \frac{1}{2}(1,200+1,600) = 1,400 \]

Using formula (4),
\[ \lambda = \left[ \frac{1}{n} \sum_{i=1}^{n} (79,500-77,100-1,400) \right] \times (25%-28%) = 6 \]

Using formula (5), adjusted forgone revenue, \( \Delta y_i \), is calculated by adding 6 (\( \lambda = 6 \)) to \( \Delta y_i \). The results are shown in Table 2.

Finally, the sum of adjusted revenue foregone of \( \Delta y_1 \) and \( \Delta y_2 \) is -772. This equals \( \Delta y_e (-772) \), which is estimated by applying \( (x_1) \) and \( (x_2) \) simultaneously. Therefore, the interactive effects have been corrected.

As a result, the sum of the adjusted revenue forgone of individual tax expenditure, as estimated separately, becomes meaningful and usable.

**b. Case Two.** In Case Two, the assumption is that the structural taxable income is \( Y_s \) in the 28 percent marginal tax rate bracket \( (t_s) \) and that structural tax interim liability is \( y_0 \). When applying the individual tax expenditure provisions, \( x_i (i = 1 \ldots n) \), the reduced taxable income is \( Y_i \) \( (i = 1 \ldots n) \), which drops into the 25 percent bracket, and the reduced tax liability is \( y_i \) \( (i = 1 \ldots n) \). Also, when applying all tax expenditure provisions simultaneously, \( \sum x_i \), the reduced taxable income is \( Y_e \), which drops into the 25 percent bracket \( (t_e) \).

Here \( Y_i = Y_s - x_i, i = 1, \ldots, n \); and \( Y_e = Y_s - \sum x_i, i = 1, \ldots, n \).

The forgone revenue estimated separately by applying individual tax expenditures provisions is presented as \( \Delta y_i \). The forgone revenue estimated using all tax expenditure provisions simultaneously is presented as \( \Delta y_e \).

Here, \( \Delta y_i = y_i - y_0 \) and \( \Delta y_e = y_e - y_0 \).

Therefore, the formula for estimating forgone individual revenue by applying each tax expenditure provision separately can be derived as:
\[ \Delta y_i = 3486.25 + \left( Y_i - 31,850 \right) \times 25\% - \left( 15698.75 + \left( Y_s - 77,100 \right) \times 28\% \right) \]
\[ = 3486.25 + \left( Y_i - 31,850 \right) \times 25\% - \left( 4386.28 + \left( 77,100 - 31,850 \right) \times 25\% \right) \]
\[ = \left( Y_s - 77,100 \right) \times 25\% + \left( 77,100 - 31,850 \right) \times 25\% - \sum x_i \times 25\% \]
\[ = \left( Y_s - 77,100 \right) \times (25%-28%) - \sum x_i \times 25\% \] \( i = 1 \ldots n \), and the formula for the sum of all forgone individual revenue is derived as:

**Table 2. Adjusted Estimates of Revenue Foregone for Individual Tax Expenditures**

<table>
<thead>
<tr>
<th>Taxpayer (single)</th>
<th>Tax expenditure provision</th>
<th>Taxable income (Y)</th>
<th>Applicable marginal tax rate</th>
<th>Tax liabilities (y)</th>
<th>Revenue foregone (( \Delta y ))</th>
<th>Revenue foregone (adjusted) (( \Delta y' ))</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structural</td>
<td></td>
<td>$79,500</td>
<td>28%</td>
<td>$16,370.75</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Applying individual deductions independently</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Deduction X1</td>
<td></td>
<td>$1,200</td>
<td>28%</td>
<td>$16,034.75</td>
<td>-$336.00</td>
<td>-$330.00</td>
</tr>
<tr>
<td>2. Deduction X2</td>
<td></td>
<td>1,600</td>
<td>28%</td>
<td>15,922.75</td>
<td>-$448.00</td>
<td>-$442.00</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-$784.00</td>
<td>-$772.00</td>
</tr>
<tr>
<td>B. Applying all deductions (X1 + X2)</td>
<td></td>
<td>2,800</td>
<td>25%</td>
<td>15,598.75</td>
<td>-$772.00</td>
<td>-$772.00</td>
</tr>
<tr>
<td>Interactive Effects</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>12.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>

*Based on 2007 Tax Rate Schedules Internal Revenue Service.
As a result, the interactive effects do not exist when adjusting $\Delta y_i$ (i = 1, ..., n) by adding the adjustment factor $\lambda$ to it.

Therefore, using adjusted forgone revenue, the sum of forgone individual revenue estimated separately equals the forgone revenue estimated by applying all tax expenditure provisions simultaneously.

Table 3 above gives an example. Based on formula (8), $\lambda = \frac{1}{2} \left[ (79,500-77,100) \right] \ast (28\%-25\%) = \frac{1}{2} \left( 2,400 \right) \ast 0.03 = 36$

Using formula (9), adjusted forgone revenue, $\Delta y_{i}$ (i = 1 and 2), is calculated by adding 36 ($\lambda = 36$) to $\Delta y_i$ (i = 1 and 2). The results are shown in Table 3.

Finally, the sum of adjusted forgone revenue of $\Delta y_i$ and $\Delta y_j$ is -3,697, which equals $\Delta y_{ij}$ (-3,697), when applying (x1) and (x2) simultaneously. As a result of using the adjustment factor, the interactive effects have been corrected.

As a result, the sum of the adjusted forgone revenue of individual tax expenditure, as estimated separately, becomes meaningful and usable.

**c. Case Three.** In Case Three, the assumption is that the structural taxable income is $Y_s$ in the 28 percent marginal tax rate bracket ($t_s$) and that structural tax interim liability is $y_0$. There are tax expenditure provisions $x_i$ (i = 1, ..., j - 1, ..., n). When applying certain individual tax expenditure provisions separately, $x_i$ (i = 1, ..., j - 1), the reduced taxable income is $Y_i$ (i = 1, ..., j - 1), which stays in the 28 percent bracket, and the tax liability is $y_i$ (i = 1, ..., j - 1). However, when applying certain other individual tax expenditure provisions, $x_i$ (i = j, ..., n), separately, the reduced taxable income $Y_i$ (i = j, ..., n) drops into the 25 percent bracket, and the reduced tax liability is $y_i$ (i = j, ..., n). Also, when simultaneously applying all tax expenditure provisions, $\Sigma x_i$, the reduced taxable income is $Y_a$, which drops into the 25 percent bracket ($t_a$).

As a result, the interactive effects do not exist when adjusting $\Delta y_i$ (i = 1, ..., n) by adding the adjustment factor $\lambda$ to it.

Therefore, using adjusted forgone revenue, the sum of forgone individual revenue estimated separately equals the forgone revenue estimated by applying all tax expenditure provisions simultaneously.

Table 3 above gives an example. Based on formula (8), $\lambda = \frac{1}{2} \left[ (79,500-77,100) \right] \ast (28\%-25\%) = \frac{1}{2} \left( 2,400 \right) \ast 0.03 = 36$

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Finally, the sum of adjusted forgone revenue of $\Delta y_i$ and $\Delta y_j$ is -3,697, which equals $\Delta y_{ij}$ (-3,697), when applying (x1) and (x2) simultaneously. As a result of using the adjustment factor, the interactive effects have been corrected.

As a result, the sum of the adjusted forgone revenue of individual tax expenditure, as estimated separately, becomes meaningful and usable.

### Table 3. Adjusted Estimates of Revenue Foregone for Individual Tax Expenditures

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<thead>
<tr>
<th>Taxpayer (single)</th>
<th>Tax expenditure provision</th>
<th>Taxable income (Y)</th>
<th>Applicable marginal tax rate</th>
<th>Tax liabilities (y)</th>
<th>Revenue foregone ((\Delta y))</th>
<th>Revenue foregone (adjusted) ((\Delta y'))</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td><strong>A. Applying individual deductions independently</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Deduction X1</td>
<td>$12,000</td>
<td>67,500</td>
<td>25%</td>
<td>13,298.75</td>
<td>-3,072.00</td>
<td>-3,036.00</td>
</tr>
<tr>
<td>2. Deduction X2</td>
<td>2,500</td>
<td>77,000</td>
<td>25%</td>
<td>15,673.75</td>
<td>-697.00</td>
<td>-661.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-3769.00</td>
</tr>
<tr>
<td><strong>B. Applying all deductions</strong> (X1+X2)</td>
<td>14,500</td>
<td>65,000</td>
<td>25%</td>
<td>12,673.75</td>
<td>-3,697.00</td>
<td>-3,697.00</td>
</tr>
<tr>
<td>Interactive Effects</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>72.00</td>
</tr>
</tbody>
</table>

As a result, the interactive effects do not exist when adjusting $\Delta y_i$ (i = 1, ..., n) by adding the adjustment factor $\lambda$ to it.

Therefore, using adjusted forgone revenue, the sum of forgone individual revenue estimated separately equals the forgone revenue estimated by applying all tax expenditure provisions simultaneously.

Table 3 above gives an example. Based on formula (8), $\lambda = \frac{1}{2} \left[ (79,500-77,100) \right] \ast (28\%-25\%) = \frac{1}{2} \left( 2,400 \right) \ast 0.03 = 36$

Using formula (9), adjusted forgone revenue, $\Delta y_{i}$ (i = 1 and 2), is calculated by adding 36 ($\lambda = 36$) to $\Delta y_i$ (i = 1 and 2). The results are shown in Table 3.

Finally, the sum of adjusted forgone revenue of $\Delta y_i$ and $\Delta y_j$ is -3,697, which equals $\Delta y_{ij}$ (-3,697), when applying (x1) and (x2) simultaneously. As a result of using the adjustment factor, the interactive effects have been corrected.

As a result, the sum of the adjusted forgone revenue of individual tax expenditure, as estimated separately, becomes meaningful and usable.
COMMENTARY / VIEWPOINTS

estimated by applying all tax expenditure provisions simultaneously is presented as \( \Delta y_e \).

\[
\Delta y_i = y_i - y_0 \quad (i = 1 \ldots j - 1, \ldots, n),
\]

and \( \Delta y_e = y_e - y_0 \).

Therefore, \( \sum \Delta y_i = \sum \Delta y_i + \sum \Delta y_i \).

Based on formula (1), when applying individual tax expenditure provisions, \( x_i \), \( i = 1, \ldots, j - 1 \) separately, the reduced taxable income stays in the 28 percent tax rate bracket, and the sum of forgone revenue, \( \sum \Delta y_i \), is calculated as follows:

\[
\sum \Delta y_i = - \sum x_i \times 28%.
\]

Based on formula (6), when applying individual tax expenditure provisions, \( x_i, i = j, \ldots, n \) separately, the sum of forgone revenue, \( \sum \Delta y_i \), is calculated as follows:

\[
\sum \Delta y_i = \sum (X_i - 77,100) \times (28\% - 25\%) \times \sum x_i \times 25%.
\]

Thus, \( \sum \Delta y_i = \sum \Delta y_i + \sum \Delta y_i \)

\[
= - \sum x_i \times 28% + \sum (X_i - 77,100) \times (28\% - 25\%) + \sum x_i \times 25% \quad (10)
\]

Based on formula (2), the estimated forgone revenue, by applying all tax expenditure provisions simultaneously, is calculated as follows:

\[
\Delta y_e = (X_i - 77,100) \times (25\% - 28\%) - \sum x_i \times 25%.
\]

Therefore, the sum of interactive effects is, using formulas (10) and (2),

\[
\Delta y_e = \sum \Delta y_i = \sum \Delta y_i (n-j) \times (X_i - 77,100) \times (28\% - 25\%) + \sum x_i \times 28% + \sum x_i \times 25% \quad (11)
\]

Based on formula (11), the adjustment factor \( \lambda \) can be derived with n tax expenditure provisions as follows:

\[
\lambda = \frac{n-1}{n} \times (X_i - 77,100) \times (28\% - 25\%) \times \frac{1}{n} \sum X_i \times 28%\% = \frac{n-1}{n} \times (X_i - 77,100) \times (28\% - 25\%) \times \frac{1}{n} \sum X_i \times 28%\%
\]

Where \( \sum X_i = (j-1) \times \sum x_i \times 25% \) is the mean of \( x_i \), \( i = 1 \ldots j-1 \).

Therefore, to add \( \lambda \) to adjust \( \Delta y_e \), the formula for adjusted forgone revenue \( \Delta y \), is as follows:

\[
\Delta y = \Delta y_e + \lambda
\]

As a result, there are two situations that have to be treated separately in adjusting the forgone revenue (these two situations are labeled (a) and (b) below).

(a) When \( i = 1, \ldots, j-1 \),

\[
\Delta y_i = \frac{n-1}{n} \times (X_i - 77,100) \times (28\% - 25\%) \times \frac{1}{n} \sum x_i \times 28% - x_i \times 28% \quad (13)
\]

Therefore,

\[
\sum \Delta y_i = \frac{(n-1)(1-j)}{n} \times (X_i - 77,100) \times (28\% - 25\%) + \frac{1}{n} \times \sum x_i \times 28% \quad (14)
\]

(b) When \( i = j, \ldots, n \)

\[
\Delta y_i = \Delta y_e + \lambda
\]

\[
= (X_i - 77,100) \times (25\% - 28\%) - x_i \times 25% + \frac{n-1}{n} \times (X_i - 77,100) \times (28\% - 25\%) + \frac{1}{n} \times \sum x_i \times 28% \quad (15)
\]

Therefore,

\[
\sum \Delta y_i = \frac{j}{n} \times (X_i - 77,100) \times (28\% - 25\%) + \frac{1}{n} \times \sum x_i \times 25% \quad (16)
\]

To examine the interactive effects, we can calculate the difference between \( \Delta y \), and the sum of the estimates of adjusted forgone revenue, \( \Delta y \).

\[
\Delta y_e - \sum \Delta y_i = \Delta y_e - (\sum \Delta y_i + \sum \Delta y_i)
\]

\[
= (X_i - 77,100) \times (25\% - 28\%) - \sum x_i \times 25% - \frac{(n-1)(1-j)}{n} \times (X_i - 77,100) \times (28\% - 25\%) - \frac{1}{n} \times \sum x_i \times 28%\% - \frac{(j-1)(1-j)}{n} \times \sum x_i \times 25%\%
\]

\[
= (X_i - 77,100) \times (25\% - 28\%) - (X_i - 77,100) \times (25\% - 28\%) - \sum x_i \times 25% - \sum x_i \times 25% - \sum x_i \times 28% + \sum x_i \times 25%\%
\]

\[
= 0
\]

As a result, the interactive effects do not exist when using adjusted \( \Delta y \), by adding the adjustment factor \( \lambda \) to \( \Delta y \), \( i = 1, \ldots, j-1, j, \ldots, n \).

Therefore, using adjusted forgone revenue, the sum of forgone individual revenue estimated separately equals the forgone revenue estimated by applying all tax expenditure provisions simultaneously.

Table 4 above gives an example.
In this example, there are four tax expenditure provisions, $i = 1, 2, 3,\text{ and } 4$. Here, $n = 4$, $j = 3$, $j-1 = 2$. Based on formula (12), can be calculated as

$$\lambda = \frac{n_j}{n} \sum_{j-1}^{1} x_i (28\%-25\%) + \frac{1}{4} \sum_{i=1}^{n}(79,500-77,100) (28\%-25\%)$$

$$= \frac{3}{4} \sum_{i=1}^{n}(79,500-77,100) (28\%-25\%)$$

$$= 39$$

Using formulas (13) and (15), adjusted forgone revenue, $\Delta y_i(i = 1, 2, 3,\text{ and } 4)$, is calculated by adding 39 to $\Delta y_i(i = 1, 2, 3,\text{ and } 4)$. The results are shown in Table 4.

After using the adjustment factor $\lambda$, the sum of adjusted revenue forgone, $\Delta y_i(i = 1, 2, 3,\text{ and } 4)$, is (-4,397). This equals $\Delta y_i$, which is (-4,397), calculated by applying $x_i$ to $\Delta y_i(i = 1, 2, 3,\text{ and } 4)$. The sum of the interactive effects is zero. Therefore, the interactive effects have been corrected.

As a result, by using the adjusted forgone revenue, the sum of the revenue forgone of individual tax expenditure as estimated separately becomes meaningful and usable.

2. Generalized formulas for adjustment factors and estimates of adjusted forgone revenue.

The assumption will be that structural taxable income, before applying for tax expenditure provisions, is $Y_i$, which falls into marginal tax rate $T_i(i = 1, 2, 3,\text{ and } 4)$, $\alpha_i(i = 1, 2, 3,\text{ and } 4)$, and assumes a tax liability, $y_i(i = 1, 2, 3,\text{ and } 4)$.

When applying individual tax expenditure provisions $x_i(i = 1, \ldots, n)$ separately, the reduced taxable income is $Y_i(i = 1, \ldots, n)$, which falls into marginal rate bracket $T_i(i = 1, \ldots, n)$, is over the amount of $x_i(i = 1, \ldots, n)$ and assumes a tax liability, $y_i(i = 1, \ldots, n)$.

When applying all tax expenditure provisions together, $\sum x_i$, the reduced taxable income is $Y_\nu$, which falls into marginal rate bracket $T_\nu$, is over the amount of $x_i$, and assumes a tax liability, $y_\nu$.

The relationship of $Y_\nu$, $T_\nu$, $y_\nu$, and $x_i(i = 1, \ldots, n)$, is shown in the 2007 tax rate schedules below.

In generalizing the formulas for the adjustment factors ($\lambda$) and for the adjusted individual revenue forgone ($\Delta y_i(i = 1, \ldots, n)$) as estimates by applying individual tax expenditure provisions separately, we will use the formulas that were created in the three cases previously discussed.

a. Case One. When each individual tax expenditure provision $x_i(i = 1, \ldots, n)$ separately, the reduced taxable income is $Y_i(i = 1, \ldots, n)$, which falls into marginal rate bracket $T_i(i = 1, \ldots, n)$, and assumes a tax liability, $y_i(i = 1, \ldots, n)$.

Previously generated formulas (4) and (5) are as follows:

### Table 4. Adjusted Estimates of Revenue Foregone for Individual Tax Expenditures

<table>
<thead>
<tr>
<th>Taxpayer (single)</th>
<th>Tax expenditure provision</th>
<th>Taxable income ($Y$)</th>
<th>Applicable marginal tax rate</th>
<th>Tax liabilities ($y$)</th>
<th>Revenue forgone ($\Delta y$)</th>
<th>Revenue forgone (adjusted) ($\Delta y'$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structural</td>
<td>$\text{structural }$</td>
<td>$79,500$</td>
<td>28%</td>
<td>$16,370.75$</td>
<td>-$336.00$</td>
<td>-$297.00</td>
</tr>
<tr>
<td>A. Applying individual deductions independently</td>
<td>1. Deduction $X_1$</td>
<td>$1,200$</td>
<td>28%</td>
<td>$16,034.75$</td>
<td>-$336.00</td>
<td>-$297.00</td>
</tr>
<tr>
<td></td>
<td>2. Deduction $X_2$</td>
<td>$1,600$</td>
<td>28%</td>
<td>$15,922.75$</td>
<td>-$448.00</td>
<td>-$409.00</td>
</tr>
<tr>
<td></td>
<td>3. Deduction $X_3$</td>
<td>$12,000$</td>
<td>25%</td>
<td>$13,298.75$</td>
<td>-$3,072.00</td>
<td>-$3,033.00</td>
</tr>
<tr>
<td></td>
<td>4. Deduction $X_4$</td>
<td>$2,500$</td>
<td>25%</td>
<td>$15,673.75$</td>
<td>-$697.00</td>
<td>-$658.00</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>$17,300$</td>
<td>25%</td>
<td>$11,973.75$</td>
<td>-$4,397.00</td>
<td>-$4,397.00</td>
</tr>
<tr>
<td>B. Applying all deductions ($X_1 + X_2 + X_3 + X_4$)</td>
<td>17,300</td>
<td>25%</td>
<td>$11,973.75$</td>
<td>-$4,397.00</td>
<td>-$4,397.00</td>
<td></td>
</tr>
<tr>
<td>Interactive Effects</td>
<td></td>
<td></td>
<td></td>
<td>156.00</td>
<td>0.00</td>
<td></td>
</tr>
</tbody>
</table>

*Based on 2007 Tax Rate Schedules, Internal Revenue Service.*

<table>
<thead>
<tr>
<th>If your taxable income is over . . .</th>
<th>But not over . . .</th>
<th>Marginal tax rate</th>
<th>The tax is . . .</th>
<th>Of the amount over . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$7,825</td>
<td>10%</td>
<td>$782.50</td>
<td>$0</td>
</tr>
<tr>
<td>$7,825</td>
<td>$31,850</td>
<td>15%</td>
<td>$4,386.25</td>
<td>$31,850</td>
</tr>
<tr>
<td>$31,850</td>
<td>$77,100</td>
<td>25%</td>
<td>$15,698.75</td>
<td>$77,100</td>
</tr>
<tr>
<td>$77,100</td>
<td>$160,850</td>
<td>28%</td>
<td>$39,148.75</td>
<td>$160,850</td>
</tr>
<tr>
<td>$160,850</td>
<td>$349,700</td>
<td>33%</td>
<td>$101,469.25</td>
<td>$349,700</td>
</tr>
<tr>
<td>$349,700</td>
<td>. . .</td>
<td>35%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: 1040 Instructions, Internal Revenue Service, 2008*

2007 Tax Rate Schedules

Schedule X — if your filing status is Single

<table>
<thead>
<tr>
<th>If your taxable income is over . . .</th>
<th>But not over . . .</th>
<th>Marginal tax rate</th>
<th>The tax is . . .</th>
<th>Of the amount over . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$7,825</td>
<td>10%</td>
<td>$782.50</td>
<td>$0</td>
</tr>
<tr>
<td>$7,825</td>
<td>$31,850</td>
<td>15%</td>
<td>$4,386.25</td>
<td>$31,850</td>
</tr>
<tr>
<td>$31,850</td>
<td>$77,100</td>
<td>25%</td>
<td>$15,698.75</td>
<td>$77,100</td>
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<tr>
<td>$77,100</td>
<td>$160,850</td>
<td>28%</td>
<td>$39,148.75</td>
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<td>$160,850</td>
<td>$349,700</td>
<td>33%</td>
<td>$101,469.25</td>
<td>$349,700</td>
</tr>
<tr>
<td>$349,700</td>
<td>. . .</td>
<td>35%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: 1040 Instructions, Internal Revenue Service, 2008*
\[ \lambda = \frac{1}{\pi} (Y_{s77,100} \cdot (25\%-28\%) - \frac{1}{\pi} \sum x_i \cdot (25\%-28\%) \] (4)

\[ \Delta y_i = -x_i \cdot 28\% + \left[ \frac{1}{\pi} (Y_{s77,100} - \pi \cdot \tau) \right] \cdot (25\%-28\%); \quad i = 1, \ldots, n. \] (5)

In this case \( T_i = T_0 \), thus, the formulas can be generalized as follows:

\[ \lambda = \frac{1}{\pi} (Y_0 - a_0) \cdot (T_0 - T_e) - \frac{1}{\pi} \sum x_i \cdot (T_e - T_0) \] (A1)

\[ \Delta y_i = -x_i \cdot T_0 + \left[ \frac{1}{\pi} (Y_0 - a_0) \cdot \pi \cdot \tau \right] \cdot (T_e - T_0); \quad i = 1, \ldots, n \] (B1)

b. Case Two. When each individual tax expenditure provision is applied separately, the reduced taxable income drops into the next lower marginal tax rate bracket. Also, when all tax expenditure provisions are applied simultaneously, the reduced taxable income drops into the next lower bracket.

Previously generated formulas (8) and (9) are as follows:

\[ \lambda = \frac{n-1}{\pi} (Y_{s77,100} \cdot (28\%-25\%)) \] (8)

\[ \Delta y_i = -x_i \cdot 25\% - \frac{1}{\pi} (Y_{s77,100} \cdot (28\%-25\%)), \quad i = 1, \ldots, n \] (9)

In this case \( T_i = T_0 \), thus, the formulas can be generalized as follows:

\[ \lambda = \frac{n-1}{\pi} (Y_0 - a_0) \cdot (T_0 - T_e) \] (A2)

\[ \Delta y_i = -x_i \cdot T_e - \frac{1}{\pi} (Y_0 - a_0) \cdot (T_0 - T_e); \quad i = 1, \ldots, n \] (B2)

c. Case Three. When some individual tax expenditure provisions are applied separately, the reduced taxable income stays in the same marginal tax rate bracket. However, when other individual tax expenditure provisions are applied simultaneously, the reduced taxable income drops into the next lower marginal tax rate bracket. Also, when all tax expenditure provisions are applied simultaneously, the reduced taxable income drops into the next lower bracket.

Previously generated formulas (12), (13), and (15) are as follows:

\[ \lambda = \frac{n-1}{\pi} (Y_{s77,100} \cdot (28\%-25\%)) + \frac{1}{\pi} \sum x_i \cdot (28\%-25\%) \] (12)

(a) When \( i = 1, \ldots, j-1 \)

\[ \Delta y_i = \frac{n-1}{\pi} (Y_{s77,100} \cdot (28\%-25\%)) + \frac{j-1}{\pi} \cdot \tau \cdot a \cdot (28\%-25\%) \cdot x_i \cdot 28\% \] (13)

(b) When \( i = j, \ldots, n \)

\[ \Delta y_i = \frac{j}{\pi} (Y_{s77,100} \cdot (28\%-25\%)) + \frac{j-1}{\pi} \cdot \tau \cdot a \cdot (28\%-25\%) - x_i \cdot 28\% \] (15)

Where \( \tau = \frac{1}{j-1} \sum x_i \)

In situation (a), \( T_i = T_0 \), and in situation (b), \( T_i = T_0 \), thus, the formulas can be generalized as follows:

\[ \lambda = \frac{n-1}{\pi} (Y_0 - a_0) \cdot (T_0 - T_e) + \frac{1}{\pi} \sum x_i \cdot (T_0 - T_e) \] (A3)

Therefore, when \( i = 1, \ldots, j-1 \)

\[ \Delta y_i = \frac{n-1}{\pi} (Y_0 - a_0) \cdot (T_0 - T_e) + \frac{j-1}{\pi} \cdot \tau \cdot a \cdot (T_0 - T_e) \cdot x_i \cdot T_0 \] (B3)

And, when \( i = j, \ldots, n \)

\[ \Delta y_i = \frac{j}{\pi} (Y_0 - a_0) \cdot (T_0 - T_e) + \frac{j-1}{\pi} \cdot \tau \cdot a \cdot (T_0 - T_e) - x_i \cdot T_e \] (B4)

Where \( \tau = \frac{1}{j-1} \sum x_i \)

References


P.L. 93-344, section 201(g), codified at 2 U.S.C. 601(f).


A. Introduction

The U.S. economy is mired in a severe recession that officially began in December 2007. The unemployment rate rose from 4.4 percent in March 2007 to 6.7 percent in November 2008, and nonfarm payrolls shed 1.9 million jobs from December 2007 to November 2008. Real GDP declined at a 0.5 percent annual rate in the third quarter of 2008 and undoubtedly fell much more rapidly in the fourth quarter. The Conference Board’s index of leading economic indicators fell 2.8 percent in the six months ending in November 2008, signaling the economy is likely to remain weak for at least several more months.

During recessions, the government invariably pursues policies to stimulate aggregate demand, that is, to increase spending by households, firms, and government. (In this context, spending refers to consumer purchases, business and housing investment, government purchases of goods and services, and exports net of imports.) Monetary policy can stimulate aggregate demand by expanding the money supply and thereby lowering interest rates, which increases households’ and firms’ desired spending.

Fiscal policy is another available tool. A variety of tax and spending measures can stimulate aggregate demand by increasing the amount of spending that households and firms wish to do at any given interest rate. An increase in government purchases of goods and services directly increases spending. Under some circumstances, simply giving households or firms more money through tax cuts or government transfer payments may increase consumer or investment spending to some extent. Moreover, tax measures can provide incentives, or reduce disincentives, for firms and households to engage in investment and consumer spending.

Both monetary policy and fiscal policy have been used to stimulate aggregate demand before and during the current recession. The Federal Reserve has lowered the target value of the federal funds rate 10 times, reducing it to a range of zero to 0.25 percent on December 16, 2008, down from 5.25 percent in September 2007. Congress and President Bush enacted a stimulus package in early 2008 that included tax rebates intended to bolster consumer spending and temporary incentives for some business investment.

Because interest rates cannot fall below zero, the Federal Reserve cannot further reduce short-term interest rates, although it may be able to reduce long-term interest rates to some extent. As the severity of the recession and the limits of monetary policy have become clear, support for additional fiscal stimulus has grown. After unsuccessful attempts to pass a modest stimulus package in the fall of 2008, Congress and President-elect Barack Obama are planning to consider a far larger plan this month. Obama adviser David Axelrod said December 28 that the proposed stimulus package will cost $675 billion to $775 billion and that it will include tax reductions as well as spending increases.

In this article, I consider the general principles of fiscal stimulus and the role of tax measures. Because fiscal stimulus does not create output and jobs from thin air, but “borrows” them from the future, stimulus must be properly timed to be beneficial. Although it is reasonable to pursue fiscal stimulus under today’s harrowing conditions, expectations should remain limited. Stimulus measures should be temporary or business-cycle-contingent. Government purchases do not necessarily provide a larger (correctly measured) stimulative effect than tax cuts. On a more specific note, allowing greater use of net operating loss carryforwards during recessions would be beneficial.


than during expansions can provide a modest fiscal stimulus while also reducing tax penalties on risky investment.

B. Role of Aggregate Demand Stimulus

To understand the role of tax and spending measures in stimulating aggregate demand, it is necessary to clarify the potential and the limits of stimulus.

Because of various frictions in the economy, monetary and fiscal policies that affect aggregate demand can alter the level of output relative to its natural level (the level that would prevail in the absence of frictions) while also affecting inflation.

Those frictions may include sluggish adjustment of prices and nominal wages or various types of incomplete information. Economists do not agree on the exact types of frictions, but most have rejected the notion that the economy operates in a frictionless manner. Nevertheless, the effect of stimulus measures is limited, as set forth below.

Tax and spending measures that stimulate aggregate demand change the timing of output. Those measures temporarily increase output relative to its natural level, with a subsequent "payback" in which output is temporarily reduced relative to its natural level.

For present purposes, the following provides the best simple representation of the tradeoff between inflation and output. A rise in the inflation rate is associated with a period in which output is high relative to its natural level. A fall in the inflation rate is associated with a period in which output is low relative to its natural level. Output is unaffected if the inflation rate remains stable, whether at a higher or lower level.

In such an economy, tax and spending measures cannot permanently increase output by stimulating aggregate demand. To achieve a permanent increase in output, the inflation rate would have to continue rising forever and eventually reach hyperinflation levels, which is unsustainable.

In contrast, a sustainable policy could permanently boost the inflation rate from one level to another, perhaps from 2 percent to 3 percent. In such a case, a period of temporarily high output would be associated with the rise in inflation from 2 percent to 3 percent, but the effects on output disappear as inflation stabilizes at its new level. To obtain this one-time boost to the economy, it is necessary to live with higher inflation forever.

The case described in the preceding paragraph does not apply to the current fiscal stimulus debate. To begin with, tax and spending measures that stimulate aggregate demand do not permanently boost the inflation rate, even if the measures are permanent. Also, as far as the author is aware, no one has proposed that the inflation rate be increased forever to combat the current recession.

The case applicable to the current debate is one in which inflation is temporarily increased to combat the recession. Consider an initial increase in the inflation rate from 2 percent to 3 percent, with a subsequent reduction back to 2 percent. A period of higher output is associated with the rise from 2 percent to 3 percent, and a period of lower output is associated with the decline back to 2 percent. An unaffected level of output is associated with the period during which inflation remains at 3 percent and the period after it returns to 2 percent.

In other words, tax and spending measures that stimulate aggregate demand not only fail to provide permanent employment gains, but also fail to produce a one-time gain that the economy can keep. Instead they produce a one-time gain that must be "paid back" through a one-time loss later. A fiscal stimulus package can add output and jobs in the next year or two, but unless the inflation rate is permanently increased, it will also cause a loss of output and jobs sometime later.

"Jobs" arguments for tax and spending measures are unfounded in the long run.

An argument made for many tax and spending measures is that they create jobs by increasing the production of particular goods and services. Middle-income tax cuts and other tax policies that promote consumption are said to create jobs in industries that produce and sell consumer goods. Tax incentives for business investment are said to create jobs in the industries constructing plant and equipment. Government spending on infrastructure or defense is said to create jobs in the construction or defense industries. Tax incentives and government spending that promote renewable energy are said to create green jobs.

While those arguments are made from virtually all points of the political spectrum, the above discussion indicates that they are invalid in the long run. In the long run, tax and spending measures that increase production of an item do not increase overall employment; instead, they increase employment in a particular industry while reducing employment elsewhere in the economy. Accordingly, none of those policies should be justified in the long run on the basis of job creation. The appropriate long-run levels of consumption, business investment, infrastructure and defense, and renewable-energy spending depend on the economic gains provided by using the output, not the jobs involved in producing it.

As noted above, the jobs argument has some relevance in the short run. Tax and spending measures that promote the production of certain items have stimulus effects that initially create output and jobs, albeit with a subsequent payback.
C. Guidelines for Stimulus Measures

Tax and spending measures that stimulate aggregate demand are beneficial on those grounds only if society’s need for the jobs and output initially gained is greater than its need for the jobs and output lost in the payback period. Proper timing of stimulus is therefore essential but may be difficult to achieve.

Because the initial output boost from stimulus must be paid back in the future, proper timing is essential. If stimulus provides output and jobs when they are less needed and the payback occurs when they are more needed, the net effects are harmful. As many economists have noted, however, proper timing is difficult to achieve because the desired increase in consumer spending, business or housing investment, government purchases, or net exports may take some time to occur.

Because of the severity of the current recession, the economy desperately needs additional output and jobs. Stimulus that boosts the economy in the next several months would be beneficial, despite the subsequent payback. Of course, matters become more problematic if measures enacted today take a long time to affect spending.

Tax and spending measures adopted solely to stimulate aggregate demand should not and will not apply permanently without regard to the state of the economy. They should and will be either temporary, or contingent on the state of the economy.

It is senseless to support a permanent tax or spending measure that applies in both good times and bad solely on the grounds that it will stimulate aggregate demand. Because the output and inflation effects of the policy are temporary, there is no reason to permanently maintain the policy if its only purpose is aggregate demand stimulus.

A permanent change can provide short-run stimulus, but that can be, at most, only part of the reason for adopting the policy. Consider, for example, a decision during the current recession to adopt a permanent tax incentive for business investment or to permanently increase infrastructure spending. The policy would produce a one-time output gain because of its demand stimulus, followed by a subsequent payback. Given today’s economic conditions, that effect could be beneficial, assuming that the extra business investment or infrastructure spending occurred quickly enough. But that benefit could not be the sole reason for changing investment incentives or infrastructure spending until the end of time. The stimulus could be only a favorable side effect of a policy adopted for other reasons, such as a conviction that our nation needs more business investment or infrastructure. If stimulus were the sole motivation, the policy would be temporary or would be put in place on a permanent, but business-cycle-sensitive, basis.

Similarly, it is sometimes argued that a permanent increase in households’ disposable income is a desirable way to increase consumer spending and thereby provide fiscal stimulus, because consumer spending is based on long-run, rather than current, income for many households. Again, however, a permanent change in disposable income (which would presumably require a permanent reduction in government purchases) would not be maintained solely for stimulus reasons.

In contrast, stimulus considerations could, and sometimes should, be the sole motivation for a decision to accelerate or delay a permanent change being made for other reasons. Someone who supports (on the grounds mentioned above) a permanent increase in business investment incentives or in infrastructure spending could decide on stimulus grounds to accelerate such a change to take effect during the current recession. Similarly, someone who favors (on distributional and revenue grounds) a permanent rise in the top two individual income tax brackets could decide on stimulus grounds to delay the rate increases until after the current recession, a decision that Obama may well make. Note that in each case, the change made for stimulus reasons is itself temporary, although it alters an underlying permanent measure.

Government purchases do not necessarily provide a larger (correctly measured) stimulative effect than tax cuts.

Tax changes are often regarded as inferior stimulus tools on the ground that the GDP stimulus from increases in government purchases of goods and services is larger than that from tax cuts. In general, however, it is impossible to say which policy provides a larger (correctly measured) stimulus.

The claim that government purchases have a larger stimulative effect than tax cuts arises from a simple textbook analysis. Consider, for example, a choice between a $100 tax rebate and a $100 road construction project. Suppose that 20 percent of the tax rebate is spent on domestic consumer goods, with the remainder either saved or spent on imported goods, and that the same 20 percent spending ratio applies to the wages and supplier payments generated by the road project.

Then the rebate boosts measured GDP by only $25, while the road project boosts it by $125. The rebate initially generates $20 of consumer spending plus $4 of spending in the second round (as 20 percent of the $20 received by producers of the consumer goods is spent) plus 80 cents in the third round and so on, for a total of $25. The road project produces the same $25 consumer spending but also provides a road that is included in measured GDP at a $100 value. Unlike the $100 road, the $100 rebate is not part of GDP because it is merely a transfer from some members of society to others rather than production.

The impact on measured GDP is not, however, the right criterion. The road is treated as if it is worth $100 in the GDP accounts solely because it costs $100 to build (in accordance with the accounts’ general treatment of government transactions). The actual value of the road to its
users may be either smaller or larger than that amount. In the extreme case of a worthless road, the actual improvement in (valued) output is $25 for each of the two policies. Also, the road construction, unlike the rebates, requires workers to give up their time and provide effort. In general, the road is the better option only if its value to its users exceeds the value of the workers’ time.8

The road is inferior to the rebate if it has little value to its users. However, the road is better than the rebate if it has a large value to its users; indeed, it may then be superior by a wider margin than the textbook analysis indicates. It is necessary to scrutinize the value of each project; we cannot rely on generalizations about government purchases being better or worse than tax rebates.

This analysis highlights the importance of proper project selection. If infrastructure investment is to be a large component of the stimulus package, it is imperative that wasteful projects be avoided.

D. Loss Carrybacks

A large literature has discussed the relative merits of different stimulus measures, such as tax rebates, transfer payments, government purchases, and temporary investment incentives.9 I will not review that discussion here, except to note that the literature has yet to identify a powerful stimulus measure that can be applied broadly. Instead, I discuss a specific policy option that has received less attention than it deserves. Allowing greater carrybacks of NOLs during recessions would serve a useful, although small, stimulus function while reducing the tax penalty on risky investments.

NOL carrybacks should be more generous during recessions than during economic expansions. Section 172(b)(1)(A) generally allows NOLs to be carried back 2 years or to be carried forward (without interest) for 20 years. As set forth in section 172(b)(1)(H), a five-year carryback applied to losses arising in 2001 and 2002, a change that was adopted as part of the 2002 fiscal stimulus package.10 Another temporary five-year carryback provision is being considered.11

As the Congressional Budget Office has noted, allowing greater use of NOLs can strengthen investment incentives to a modest extent. A firm that has unused loss deductions obtains no current benefit from deductions for new investment, which blunts its incentive to invest. In particular, such a firm is less likely to respond to any temporary investment incentive provisions included in a stimulus package. If a more generous NOL carryback allows a firm to move out of an excess-loss position, it faces greater marginal incentives to make new invest-

ments, particularly those that qualify for expensing or other large upfront deductions. More generous carrybacks also provide firms with cash flow, which may prompt investment if they are constrained from borrowing, a common situation today.12

Still, as the CBO comments, NOL changes are “unlikely to generate substantial changes in investment in the short run.” The best case for allowing more generous NOL carryback during recessions is the need to reduce tax penalties on risky investment.

If all losses reported on tax returns were real losses arising from risky investments that were intended, ante, to generate profits, then losses should be fully deducted at the same tax rate that applies to profits, with any resulting negative tax liability refunded in cash. Only that policy provides neutral treatment for risky investments relative to safe investments; any more restrictive policy offers firms a “heads I win, tails you lose” deal that penalizes them for taking risks.

Unfortunately, some restrictions on loss deductions are likely to be necessary because some losses may be spurious, arising from code provisions that mismeasure income — and some losses may be claimed in connection with outright tax evasion. Although the restrictions disallow some genuine losses and thereby penalize risky investments, they safeguard the Treasury from unlimited deduction of spurious losses.

The extent to which loss deductions should be allowed reflects a balancing between the desire to allow true losses and to disallow spurious losses. That implies, however, that more generous loss deductions should be allowed during recessions. During a recession, a higher fraction of reported losses are likely to be true losses caused by the bad economy, while a lower fraction are likely to be spurious.

In short, allowing firms to deduct losses if a future recession causes their risky investments to go sour helps level the playing field. The loss deductions provide the appropriate counterbalance to the taxes that firms will pay on their gains if a future economic upturn boosts the payoffs from their risky investments.13

Strictly speaking, this level-playing-field argument primarily implies that firms should be assured of loss deductions during future recessions for risky investments they will undertake in coming years. It does not directly imply that firms should receive more generous loss deductions during the current recession for risky investments that they have already undertaken. Allowing a longer carryback during the current recession, however, is probably the most direct way to provide an assurance about policy during future recessions (and, as noted above, is also modestly useful as stimulus). Consideration should be given to amending section 172 to give the Treasury secretary regulatory authority to lengthen the carryback period during future recessions.

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8 This point was recently developed by N. Gregory Mankiw, “How Not to Stimulate the Economy,” Greg Mankiw’s blog, Dec. 22, 2008 (http://gregmankiw.blogspot.com/2008/12/how-not-to-stimulate-economy.html).

9 See the sources listed in supra note 7, and the references that they cite.


12 CBO, supra note 7, p. 16.

13 A similar argument suggests that the $3,000 limit on deductions of net capital losses, as set forth in section 1211(b), should be loosened during recessions or bear markets. That change would probably have no appreciable stimulus effects.
E. Conclusion

The above analysis suggests several conclusions. The potential role of tax and spending measures as stimulus should not be overstated; fiscal stimulus borrows output from the future rather than creating it from nothing. Proper timing is essential and may be difficult to achieve. Stimulus measures should be temporary or business-cycle-contingent. Government purchases do not necessarily provide a larger (correctly measured) stimulative effect than tax cuts. Allowing greater use of NOL carry-forwards during recessions would provide a modest fiscal stimulus while also reducing tax penalties on risky investment.

As a final note, the stimulus debate should supplement, rather than replace, the quest for long-run growth. To that end, tax policy should be oriented to tax consumption rather than saving. It should also keep marginal tax rates as low as reasonably possible. As we address the current economic calamity, let’s also adopt policies that will continue to enable each generation to attain a higher standard of living.
In-House Advertisement
Intentionally Removed
Talking Tax: Inaugurations and The Rhetoric of Revenue

By Joseph J. Thorndike

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When Barack Obama delivers his inaugural address next week, how much are we likely to hear about taxes? If history is any guide, not much. Tax professionals may find it hard to believe, but when new presidents reach for stirring rhetoric, they don’t start talking tax.

Democratic presidents have been particularly averse to inaugural tax talk. For a party reputed to love taxes, they clearly don’t like to talk about them. Even the greatest tax-and-spenders of all time, Franklin D. Roosevelt, proved unwilling to discuss the subject — only once did he even mention the “T” word in three trips to the Capitol steps. (FDR’s fourth inauguration, in 1945, took place at the White House, with festivities canceled because of the war; and no, he didn’t talk about taxes then, either.)

Still, the history of inaugural tax talk is worth a quick review, if only to confirm the popularity of a well-trod rhetorical trope: Taxation as an intolerable, anti-American burden.

McKinley

For the sake of brevity and relevance, let’s confine this survey to the modern tax era, starting in 1897 when federal taxes — and income levies in particular — were a hot topic of national debate. In his first inaugural address, President William McKinley managed to bury the notion of a permanent federal income tax and confirm his preference for a protective tariff.

“It is the settled policy of the Government, pursued from the beginning and practiced by all parties and Administrations, to raise the bulk of our revenue from taxes upon foreign productions entering the United States for sale and consumption, and avoiding, for the most part, every form of direct taxation, except in time of war,” McKinley declared. “The country is clearly opposed to any needless additions to the subject of internal taxation, and is committed by its latest popular utterance to the system of tariff taxation.”

McKinley was simply confirming the Republican Party’s long-standing support for steep protective tariffs, ostensibly designed to protect the interests of both capital and labor. And while he never mentioned the income tax by name, he was clearly serving notice that no such levy would win his approval, despite its growing popularity among workers, farmers, and Democrats (not to mention a few progressive Republicans).

The next year, McKinley would be forced to accept a variety of new internal taxes to help finance the Spanish-American War. But even under the pressure of war, he and his fellow Republican leaders remained staunchly opposed to the income tax.

When McKinley delivered his second inaugural address in 1901, he mentioned taxes only once, taking credit for their reduction the previous year.

Taft

In his 1905 inaugural address, Theodore Roosevelt never mentioned taxes at all. The omission was striking, given Roosevelt’s support for progressive tax reform, including a permanent federal estate tax. Instead, it fell to Roosevelt’s handpicked successor, William Howard Taft, to make the Republican case for progressive reform.

Taking office in 1909, Taft faced the prospect of a $100 million deficit. Like every major political figure of his era, he considered such a shortfall intolerable. “It is imperative that such a deficit shall not continue,” he said. Lawmakers must revise the tariff to produce additional revenue. And if that proved impossible, then they should devise new taxes to cover the shortfall. “Among these I recommend a graduated inheritance tax as correct in principle and as certain and easy of collection,” he added.

It would take the better part of a decade, but Congress would eventually take his advice.

Harding

Woodrow Wilson presided over the introduction of the modern income tax in 1913, but his inaugural rhetoric made scant mention of tax issues. In 1913 he noted in passing the unfairness of a heavy protective tariff, which Democrats resented for the burden it placed on consumers. But he offered no alternatives. In 1917, having orchestrated a monumental increase in federal taxes during World War I, Wilson avoided the topic entirely.

Once again it fell to a Republican to talk about tax. In his 1921 inaugural address, Warren G. Harding almost rose to the level of eloquence while outlining his plans to reduce high wartime taxes and scale back federal spending:

We can reduce the abnormal expenditures, and we will. We can strike at war taxation, and we must. We must face the grim necessity, with full knowledge that the task is to be solved, and we must proceed with a full realization that no statute enacted by man can repeal the inexorable laws of nature. Our most dangerous tendency is to expect too much of government, and at the same time do for it too little. We contemplate the immediate task of putting our public household in order. We need a rigid and yet sane economy, combined with fiscal justice, and it must be attended by individual
prudence and thrift, which are so essential to this trying hour and reassuring for the future.

Harding began the postwar rollback in federal tax burdens — a project that many Democrats also supported (although more than a few hoped to retain heavy taxes on business profits).

Coolidge

But when it came to Republican tax rhetoric, Harding was quickly eclipsed by his successor, Calvin Coolidge. Taking office after Harding died from a heart attack in 1923, Coolidge quickly established himself as an ardent tax cutter. Indeed, he spoke more — and more passionately — about taxes than any president before or since. “The collection of any taxes which are not absolutely required, which do not beyond reasonable doubt contribute to the public welfare, is only a species of legalized larceny,” he famously declared in 1925. “Under this republic the rewards of industry belong to those who earn them. The only constitutional tax is the tax which ministers to public necessity. The property of the country belongs to the people of the country. Their title is absolute.”

Coolidge insisted that cuts be aimed at the rich, as well as the poor and middle class. He rejected the moral legitimacy of a steeply progressive rate structure, like the one established during World War I:

I am opposed to extremely high rates, because they produce little or no revenue, because they are bad for the country, and, finally, because they are wrong. We cannot finance the country, we cannot improve social conditions, through any system of injustice, even if we attempt to inflict it upon the rich. Those who suffer the most harm will be the poor. This country believes in prosperity. It is absurd to suppose that it is envious of those who are already prosperous. The wise and correct course to follow in taxation and all other economic legislation is not to destroy those who have already secured success, but to create conditions under which everyone will have a better chance to be successful. The verdict of the country has been given on this question. That verdict stands. We shall do well to heed it.

As president, Coolidge made good on his rhetoric. Tax rates declined dramatically during his term and a half in office.

The Great Silence

Herbert Hoover didn’t mention taxes in his sole inaugural address, delivered in 1929. Franklin Roosevelt made a passing reference to them in 1933, taking a swipe at Hoover for the 1932 tax increase. But in his next three inaugural addresses, FDR never again let the word pass his lips — a striking silence for a chief executive who made progressive tax reform a centerpiece of his economic program in the 1930s and who presided over the creation of the modern tax regime during World War II.

Later presidents followed FDR’s lead: Taxes disappeared entirely from inaugural addresses for more than half a century. Practitioners of the modern rhetorical presidency, Democrat and Republican alike, apparently decided that taxes were not the stuff of stirring speeches.

Even presidents who would go on to champion important tax reforms, like Kennedy in 1961, chose to avoid the subject.

The Great Communicator

So who would revive the tradition of inaugural tax talk? Ronald Reagan, of course, the most ardent tax cutter to occupy the Oval Office since Coolidge. (Not surprisingly, Reagan famously chose Coolidge’s portrait for a prominent place in the Cabinet Room.) Taking office in the midst of economic turmoil, Reagan pointed to taxes as a key culprit in the nation’s decline. “Idle industries have cast workers into unemployment, human misery, and personal indignity,” he declared in 1981. “Those who do work are denied a fair return for their labor by a tax system which penalizes successful achievement and keeps us from maintaining full productivity.”

Like Coolidge, Reagan could wax eloquent on taxation, imbuing this, the driest of political topics, with at least a modicum of excitement — or indignation:

In the days ahead I will propose removing the roadblocks that have slowed our economy and reduced productivity. Steps will be taken aimed at restoring the balance between the various levels of government. Progress may be slow, measured in inches and feet, not miles, but we will progress. It is time to reawaken this industrial giant, to get government back within its means, and to lighten our punitive tax burden. And these will be our first priorities and on these principles there will be no compromise.

In his second inaugural address, Reagan had even more to say about taxes. He took more than a few moments to glory in the tax cuts of his first term. “By 1980 we knew it was time to renew our faith, to strive with all our strength toward the ultimate in individual freedom, consistent with an orderly society,” he recalled. “We believed then and now: There are no limits to growth and human progress when men and women are free to follow their dreams. And we were right to believe that. Tax rates have been reduced, inflation cut dramatically, and more people are employed than ever before in our history.”

But more important, Reagan went on to call for further tax reform, invoking the need for simplification. He also called for a balanced budget amendment to halt the growth of government. “We must take further steps to permanently control government’s power to tax and spend,” he said. “We must act now to protect future generations from government’s desire to spend its citizens’ money and tax them into servitude when the bills come due.”

Servitude! Silent Cal would have been proud.

After Reagan, presidents resumed their rhetorical tax avoidance. George H. W. Bush and Bill Clinton studiously sidestepped the topic, while George W. Bush mentioned it only in passing during his 2001 address. Clearly, taxes have remained unwelcome terrain for presidents intent on inspirational speechifying.

So what can we take home from all of this? Two things, I think.
First, the disappearance of inaugural tax talk after World War II reflects the bipartisan fiscal consensus that marked this era. Until 1940 or so, taxes were a centerpiece of political contest, giving Democrats and Republicans something important to argue about. But after the war, tax policy ceased to provide an organizing principle for interparty rivalry. To be sure, partisan sniping continued. But both parties embraced the broad outlines of the wartime tax regime and accepted its permanence.

Second, when it comes to tax, indignation is the only acceptable rhetorical mode. Even Democrats — ostensible champions of shared sacrifice, the common good, and communal enterprise — have been reluctant to make an affirmative case for taxation, at least from the inaugural stand. That’s why even Roosevelt chose to avoid tax rhetoric during his inaugurations.

When it comes to taxes, if you don’t have anything mean to say, then don’t say anything at all.
In-House Advertisement
Intentionally Removed
Reorganization of Insolvent Corporations
By Robert Willens

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With the intention of affording “troubled” corporations a meaningful chance for rehabilitation, Congress authorized a type of reorganization specifically for them. The section 368(a)(1)(G) reorganization (G reorganization) is available exclusively to corporations, the assets of which are transferred to another corporation in a “Title 11 or similar case” (as defined in section 368(a)(3)(A)) but only if stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under section 354, 355, or 356. In the case of an acquisitive G reorganization, the corporation to which the target’s assets are transferred must acquire substantially all of the target’s assets, and at least one shareholder of the target must receive stock of the acquiring corporation (or its parent), or at least one security holder of the target must receive stock and/or securities in the acquiring corporation. Accordingly, if the target’s shareholders receive no consideration for their stock and no target creditor holds securities, there can be no G reorganization. If the transaction qualifies as a G reorganization, the acquiring corporation inherits under section 381(a) the target’s tax attributes enumerated in section 381(c), most notably its net operating loss carryovers. The acquiring corporation will also inherit under section 362(b) the target’s basis in any assets transferred.

To qualify for the exception from taxation for specified reorganizations, reg. section 1.368-1(b) states that a taxpayer must satisfy “both the terms of the specifications and their underlying assumptions and purposes.” This means that the transaction must be carried out for one or more corporate business purposes and the transaction must exhibit continuity of business enterprise. The continuity of business enterprise requirement of reg. section 1.368-1(d)(1) is met if the acquiring corporation or any member of its qualified group either continues the target’s historic business or uses in a business a significant portion of the target’s historic business assets. Under the continuity of interest (COI) requirement, those persons who, directly or indirectly, were the owners of the enterprise before its conveyance to the acquiring corporation must maintain a continuing interest therein. Moreover, the continuing interest must be definite and material and represent a substantial part of the value of the thing transferred. See Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935).

The modern incarnation of the COI requirement will be met if, and only if, a substantial part of the value of the proprietary interests in the target corporation is preserved in the potential reorganization. See reg. section 1.368-1(e)(1)(i). For this purpose, a proprietary interest is preserved if it is exchanged for a proprietary interest in the issuing corporation. By contrast, a proprietary interest is not so preserved when, in connection with the potential reorganization, (i) it is acquired by the issuing corporation for consideration other than stock of the issuing corporation; (ii) stock of the issuing corporation furnished in exchange for a proprietary interest in the target is redeemed by the issuing corporation; or (iii) consideration received before the potential reorganization, in a redemption of, or distribution in connection with, the target’s stock, is treated as other property or money received in the exchange for purposes of section 356 (or would be so treated if the target shareholder had also received stock of the issuing corporation in exchange for stock owned by the shareholder in the target corporation).

1 Regarding the notion of a “substantial part,” the Service has announced, in recent regulations, that it considers 40 percent to be sufficient. See reg. section 1.368-1T(e)(2)(v). Example 1. This percentage represents the proportion of equity consideration to aggregate consideration received for the transferred net assets and not the relationship between the transferors’ equity in the transferee to the total equity therein. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, para. 12.21. Moreover, the consideration to be exchanged shall be valued (for purposes of determining whether the equity component of the consideration represents a substantial part thereof) not at the effective time but, instead, as of the close of the last business day before the first date on which the contract (under which the transaction will be effected) is a binding contract, but only if the contract provides for fixed consideration. See reg. section 1.368-1T(e)(2)(i).

2 However, a mere disposition of stock of the target, before the potential reorganization, to persons not related to the target or to the issuing corporation, is disregarded as is a mere disposition of the stock of the acquiring corporation, received in the potential reorganization, to persons not related to the acquiring corporation. Those concessions eliminate the notion of historical shareholder continuity (under which only stock received by historical shareholders of the target counted for COI purposes) and postmerger continuity (under which a preconceived plan or arrangement to dispose of the stock received in the potential reorganization could cause that stock to be excluded in the computation of continuing equity. See Bittker and Eustice, supra note 1. Thus, COI now focuses solely on the quality of the consideration furnished in the exchange without regard to whom it is furnished (historical shareholder or otherwise) or what those persons do with the consideration once it is received.
COMMENTARY / OF CORPORATE INTEREST

How are those principles applied to a case in which a troubled corporation is seeking the benefits of reorganization treatment? In many instances, the nominal shareholders of the target are shut out of the process and receive no consideration for their stock. Thus, the question arises whether COI can ever be satisfied when the shareholders of the target do not maintain a continuing interest in the business enterprise but, instead, the target’s creditors, in whole or in part, maintain a continuing interest. This question is answered affirmatively in recently published final regulations and, as an added benefit, the IRS has extended the G reorganization provisions to cases in which the target is merely insolvent and is not enmeshed, formally, in a Title 11 or similar case. According to the regs, the applicability of the G reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is entirely consistent with congressional intent to facilitate the rehabilitation of troubled corporations.

Creditor Claims as Proprietary Interests

Thus, new reg. section 1.368-1(e)(6)(i) provides that a creditor’s claim against a target corporation may be a proprietary interest in the target if the target is in a Title 11 or similar case, or the amount of the target’s liabilities exceeds the fair market value of its assets (that is, the target is “insolvent” as that term is defined in section 108(d)(3)) immediately before the potential reorganization.

In those cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, every claim of that class of creditors, and every claim of all and equal and junior classes (in addition to the claims of shareholders), is a proprietary interest in the target immediately before the potential reorganization to the extent provided in reg. section 1.368-1(e)(6)(ii).

For a claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class, the value of the proprietary interest in the target represented by the claim is determined by multiplying the fair value of the claim by a fraction, the numerator of which is:

• the fair value of the proprietary interests in the issuing corporation that are received, in the aggregate, in exchange for the claims of those classes of creditors; and

• the denominator of which is the sum of the amount of money and the fair value of all other consideration (including the proprietary interests in the issuing corporation) received, in the aggregate, in exchange for those claims.

The regulations provide that if only one class (or one set of equal classes) of creditors receives stock, that class (or set of equal classes) is treated as the most senior class of creditors receiving stock. Moreover, when only one class (or one set of equal classes) of creditors receives stock in exchange for a creditor’s proprietary interest in the target, that stock will be counted for measuring COI, provided that the stock is not de minimis in relation to the total consideration received by the insolvent target, its shareholders, and creditors. Finally, the regulations indicate that the value of a proprietary interest in the target held by a creditor with a claim that is junior to the claims of other classes of target creditors receiving proprietary interests in the issuing corporation shall be the fair value of the junior creditor’s claim.

Continuity of Interest

The final regs include illustrative examples. In the first example, the target, an insolvent entity, possesses assets with a fair value of $150x and is burdened by liabilities in the amount of $200x. The target has two senior creditors, A and B, with claims of $25x each, and a single junior creditor with a claim amounting to $150x. The target transfers its assets to unrelated P Corp. (P) in exchange for cash in the amount of $95x and P stock with a value of $55x. In exchange for their claims, both A and B receive $20x in cash and $5x worth of P stock. The junior creditor receives the balance of the amounts conveyed by P — $55x of the cash and P stock with a value of $45x.

The transaction in the example exhibits the requisite COI. Therefore, because the amount of the target’s liabilities exceeds the fair value of its assets, the claims of its creditors may be proprietary interests in the target. The transaction, moreover, can qualify as a G reorganization even though the target is merely insolvent and is not enmeshed in a Title 11 or similar case. Because the senior creditors of the target, A and B, receive proprietary interests in exchange for their claims, those claims and the claim of the junior creditor and the target stock are treated as proprietary interests in the target. The value of the proprietary interest of each of the senior creditors’ claims is $5x ($25x multiplied by the ratio that $10x (the fair value of the proprietary interests in the issuing corporation that are received, in the aggregate, in exchange for the claims) bears to $50x, the sum of the money and the fair value of all other consideration received, in the aggregate, in exchange for such claims). Accordingly, in the example, $5x of the stock that each of the senior creditors receives is counted in measuring COI. Further, the value of the junior creditor’s proprietary interest in the target is $100x, an amount equal to the fair value of her claim. The value of the creditors’ proprietary interests in the target, in total, is $110x and the creditors receive $55x in P stock in exchange for their proprietary interests. Consequently, a substantial part of the value of

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4A proprietary interest in the target is not preserved to the extent that creditors (or former creditors) of the target that own a proprietary interest in the corporation (or would be so treated if they had received the consideration in the potential reorganization) receive payment for their claim before the potential reorganization and the payment would be treated as other property or money received in the exchange for purposes of section 356 had it been a distribution with respect to stock. See reg. section 1.368-1(e)(1)(ii).
5If a creditor’s claim is bifurcated into a secured claim and an unsecured claim under an order in a Title 11 or similar case or under an agreement between the creditor and the debtor, the bifurcation of the claim and the allocation of consideration to each of the resulting claims will be respected for purposes of applying the rules of reg. section 1.368-1(e)(6).
the proprietary interests in the target corporation is preserved in the potential reorganization, with the result that the transaction displays the requisite COI. Whether the transaction qualifies as a G reorganization depends on whether the terms of the specifications have been met. Has P acquired substantially all of the properties of the target and will stock or securities of P be distributed in a transaction in a transaction that qualifies under section 354?

The second example — which applies to transactions occurring after December 12, 2008 — illustrates how COI can be satisfied even though one creditor within the target’s single class of creditors receives solely cash in exchange for his claim and the other creditor, within that single class, receives a combination of cash and stock in the issuing corporation. In this case, the creditors in the aggregate received $10x worth of P stock in exchange for their proprietary interests in the target, the value of which in total was $20x. Here, as in the first example, there was 50 percent continuity, and the requisite substantial part of the value of the proprietary interests in the target is preserved in the potential reorganization. Moreover, this second example is instructive because it confirms that when the stock component of the consideration transferred by the acquirer is at least 25 percent of the total consideration conveyed, the stock issued will not be regarded as de minimis in relation to the total consideration received by the insolvent target and its shareholders and creditors.
A Pro-Growth and Progressive Social Security Reform Proposal
By Mark J. Warshawsky

Mark J. Warshawsky is a member of the Social Security Advisory Board (SSAB), and was Treasury assistant secretary for economic policy from 2004 through 2006. Details of this proposal and estimates of implications for the Trust Fund, the federal budget, and retirement benefits may be found in a memorandum dated September 17, 2008, prepared by the Office of the Chief Actuary of the Social Security Administration (SSA), available at http://www.ssa.gov/OACT/solvency. The proposal is the sole opinion of the author and does not represent the views of the SSAB or the SSA.

Given current economic weakness, policymakers and analysts are now discussing the need for another stimulus package and what temporary measures it should include. I would like to propose that the essential element of a package should instead be an immediate and permanent cut in the Social Security payroll tax rate. At the same time, I put forward a proposal to deal with the long-term financial challenge facing the Social Security program. While we have been saying for several years now, appropriately so, that it is better to take action sooner rather than later for Social Security, I believe the current economic situation represents a particularly good opportunity. A lack of investor and consumer confidence is essentially what is ailing our markets and economy. What better way to boost confidence than to finally tackle a stubborn fundamental economic and fiscal problem in a way that is comprehensive, responsible, and fair, and that draws on a spirit of serious reform and bipartisanship?

A spirit of cooperation is the key to any reform of Social Security for the simple reason it affects almost every American worker through the payroll tax used to finance the system. In fact, right now, more payroll taxes are being paid by workers than are needed to pay current benefits. Those excess taxes have been used to cover the government’s profligate spending ways over many years and are an added burden on our struggling economy. To make the budget of the federal government more honest and transparent, we should cut the payroll tax immediately by 1 whole percentage point. This cut would benefit those workers most hurt by rising healthcare costs, high mortgage payments, increasing state and local taxes, and still high food prices. And this tax cut should be permanent, to be fair to future generations of workers and to encourage hiring and employment by businesses.

This is just the first step in making the Social Security tax equitable. The next step is to increase, gradually over the next three years, the amount of wages for which the Social Security tax rate applies, so that 95 percent of all workers, the historical norm, have their earnings totally included in the Social Security system. This means that in 2008 dollars, the earnings cap would be $110,000 instead of the current (in 2008) $102,000 — a seemingly modest change that will have a noticeable impact on the long-run finances of the program.

To be fair to those individuals who have spent a lifetime in the workforce, and to encourage other workers to follow a similar path, we need to create a category of “paid-up” status. After 45 years of credited earnings, all Social Security payroll taxes would be lifted.

Addressing the tax side of the equation only gets us so far on the path to strengthening Social Security. We must also address benefits by temporarily slowing the scheduled growth in future benefits, but maintaining, or even improving, their value against the steady erosion of inflation. Any change must not affect those already receiving benefits, or workers who were age 55 or older in 2005, the year President Bush cast a spotlight on the system’s financial problems. We should also recognize the rising labor-force participation rate of men and women over the age of 55, that “70 is the old 60,” and make gradual adjustments to the retirement ages accordingly.

All of the above changes, along with others affecting newly hired state and local government workers, the taxation of Social Security benefits, and discouraging unwarranted disability benefit applications by older workers, have been estimated by the Social Security Administration’s Office of the Chief Actuary to bring the system into sustainable and permanent solvency. Moreover, unlike others, this proposal would not necessitate general revenue transfers from the Treasury to achieve solvency and maintain prudent Trust Fund balances.

Most middle- and upper-income workers can expect to make up for those benefit changes through their pension or their personal 401(k) accounts. Most lower-income and disabled workers, however, do not have access to those private plans. To help those individuals overcome this challenge, we should establish a system whereby all workers who earn less than $40,000 a year would voluntarily deposit 3 percent of their pay in a personal account. The contribution for disabled workers would be paid by the government.

The federal government would provide a dollar-for-dollar match, funded by general revenues, for contributions on the first $20,000 of a person’s earnings and on a sliding scale for contributions by those earning up to $40,000. The personal accounts would be managed through an independent administrative organization providing a few simple investment options intended...
exclusively for retirement purposes. According to Social Security’s actuaries, employee contributions and government matches at those levels will be sufficient to meet needs now, and mostly exceed in the future, traditional income replacement goals, even if those workers invest conservatively in Treasury bonds.

This new system of personal accounts, plus a more robust flow of funds into employer-sponsored pension plans and personal retirement accounts, would have the salutary effect of prospectively helping markets and steadily increasing our national savings rate — just the right thing to do to help finance the growing retirement of the baby-boom generation and to reduce our nation’s dependence on foreign sources of capital like China and the Middle East.

This proposal draws on ideas that have been advocated by both Democrats and Republicans and embodies the calls for bold thinking and bipartisan solutions we heard praised on the campaign trail. More importantly, it would boost the confidence of the American people that their leaders can solve long-term problems before they turn into a crisis.
**GOVERNMENT EVENTS**

**Tuesday, January 13**  
**Filing Season.** The IRS will sponsor a 100-minute Tax Talk Today webcast on the 2009 filing season for individuals and businesses. The program is set for 2 p.m. ET. Telephone: (202) 622-4000. Web site: http://www.TaxTalkToday.tv.

**Extension of Time for Filing Returns.** The IRS has scheduled a hearing on proposed regulations (REG-115457-08) relating to the simplification of procedures for automatic extensions of time to file certain returns. The hearing is set for 10 a.m. in the IRS Auditorium.

**Thursday, January 15**  
**Employee Stock Purchase Plans.** The IRS has scheduled a hearing on proposed regulations (REG-106251-08) that clarify some rules regarding options granted under an employee stock purchase plan and provide guidance on complying with section 423. The hearing is set for 10 a.m. in the IRS Auditorium.

**Thursday, January 22**  
**New Markets Tax Credit.** The IRS has scheduled a hearing on proposed regulations (REG-142339-08) that clarify how an entity meets the requirements to be a qualified active low-income community business when its activities involve targeted populations under section 42(d)(2). The hearing is set for 10 a.m. in the IRS Auditorium.

**Friday, January 23**  
**Reporting Requirements/Cash and Noncash Charitable Contributions.** The IRS has scheduled a hearing on proposed regulations (REG-140029-07) relating to the substantiation and reporting requirements for cash and noncash charitable contributions under section 170. The hearing is set for 10 a.m. in the IRS Auditorium.

**Monday, January 26**  
**Tax-Exempt Bonds.** The IRS has scheduled a hearing on proposed regulations (REG-128841-07) on the public approval requirements under section 147(f) applicable to tax-exempt private activity bonds issued by state and local governments. The hearing is set for 10 a.m. in the IRS Auditorium.

**Monday, February 9**  
**Fuel Credits and Payments.** The IRS has scheduled a hearing on proposed regulations (REG-155087-05) on credits and payments for renewable and alternative fuels and on the definition of gasoline and diesel fuel. The hearing is set for 10 a.m. in the IRS Auditorium.

**Thursday, February 19**  
**Discharge of Partnership Indebtedness Income.** The IRS has scheduled a hearing on proposed regulations (REG-164370-05) on the application of section 108(e)(8) to partnerships and their partners, providing guidance on the determination of discharge of indebtedness income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership’s indebtedness. The hearing is set for 10 a.m. in the IRS Auditorium.

**Friday, February 20**  
**Notice Requirements/Retirement Plan Participants.** The IRS has scheduled a hearing on proposed regulations (REG-107318-08) providing that a notice of a retirement plan participant’s right to defer the receipt of immediately distributable benefits must also describe the consequences of failing to defer receipt, and that the election period for waiving the qualified joint and survivor annuity form of benefit has been expanded. The hearing is set for 10 a.m. in the IRS Auditorium.

**Tuesday, March 3**  
**Tax Shelter Case Arbitration.** The U.S. Supreme Court will hear oral arguments in Arthur Andersen LLP et al. v. Wayne Carlisle et al., Dkt. No. 08-146. At issue is whether nonsignatories to an arbitration agreement may seek a stay of proceedings pending arbitration in a case against them by investors whom they advised to engage in tax shelter transactions. Arguments are scheduled to begin at 10 a.m.

**Friday, March 13**  
**Reporting for Discharges of indebtedness.** The IRS has scheduled a hearing on proposed regulations (REG-118327-08) on the section 6050P information reporting requirements for debt cancellation. The hearing is set for 10 a.m. in the IRS Auditorium.

**Thursday, April 2**  
**Calculating Inclusion of Income From Deferred Compensation.** The IRS has scheduled a hearing on proposed regulations (REG-148326-05) on the calculation of amounts includable in income under section 409A(a) and the additional taxes for service providers participating in some nonqualified deferred compensation plans. The hearing is set for 10 a.m. in the IRS Auditorium.

**Monday, April 20**  
**Foreign Base Company Sales Income.** The IRS has scheduled a hearing on proposed regulations (REG-150066-08) providing guidance on section 954(d) foreign base company sales income in cases in which personal property sold by a controlled foreign corporation is manufactured, produced, or constructed under a contract manufacturing arrangement or by one or more branches of the CFC. The hearing is set for 10 a.m. in the IRS Auditorium.

**Tuesday, April 21**  
**Cost-Sharing Arrangements.** The IRS has scheduled a hearing on proposed regulations (REG-144615-02) on determining taxable income from cost-sharing arrangements. The hearing is set for 10 a.m. in the IRS Auditorium.

**CONTACT INFORMATION**

For further information regarding the hearings listed, contact:

**Internal Revenue Service:** Regulations Unit, CC:CORP:T:R, Assistant Chief Counsel (Corporate), Internal Revenue Service, Room 5288, Washington, DC 20224. Telephone: (202) 622-7180, ask for Hearing Clerk Kelvin Banks or Richard Hurst.

**Senate Finance Committee:** Press Officer, Senate Finance Committee, Room SD-219, Dirksen Senate Office Building, Washington, DC 20510. Telephone: (202) 224-4515.

**House Ways and Means Committee:** A telephone request to Cooper Smith, staff assistant, House Ways and Means Committee, is required. Call (202) 225-3623. The telephone request should be followed by a formal written request to Janice Mays, Chief of Staff, House Ways and Means Committee, Room 1102, Longworth House Office Building, Washington, DC 20515.
Monday, January 12


Nonprofits — New York. The Foundation for Accounting Education will sponsor a one-day conference on topics including the new Form 990, endowment funds, FIN 48, and uncertainties in UBIT. Telephone: (212) 719-8383 or (800) 533-3635. Web site: http://www.nysscpa.org. Course code: 25550911.

Monday, January 19

Financial Planning — San Diego. The American Institute of Certified Public Accountants will sponsor a three-day conference on topics including hedge funds, succession planning for small business owners, IRAs payable to trusts, Social Security, and property and casualty insurance. The location was originally announced in this calendar as Washington. Telephone: (888) 777-7077. Web site: http://www.cpa2biz.com/conferences.

Thursday, January 22

State and Local Taxation — Washington. The State and Local Taxes Committee of the D.C. Bar Taxation Section will sponsor a luncheon program on section 382 issues that are relevant to the current economic situation. This program was scheduled originally for December 16. Telephone: Leonnetta McMillon at (202) 737-4700, ext. 257. Web site: http://www.dcbar.org.

February 2, 2009. If an employee agreed to receive Form W-2 electronically, post it on a Web site accessible to the employee and notify the employee of the posting by February 2.

January 12

Employees who work for tips. If you received $20 or more in tips during December, report them to your employer. You can use Form 4070, “Employee’s Report of Tips to Employer.”

Communications and air transportation taxes under the alternative tax method. Deposit the tax included in amounts billed or tickets sold during the first 15 days of December 2008.

January 14

Regular method taxes. Deposit the tax for the last 16 days of December 2008.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on January 7-9.

January 15

Individuals. Make a payment of your estimated tax for 2008 if you did not pay your income tax for the year through withholding (or did not pay in enough tax that way). Use Form 1040-ES. This is the final installment date for 2008 estimated tax. However, you do not have to make this payment if you file your 2008 return (Form 1040) and pay any tax due by February 2, 2009.

Farmers and fishermen. Pay your estimated tax for 2008 using Form 1040-ES. You have until April 15 to file your 2008 income tax return (Form 1040). If you do not pay your estimated tax by January 15, you must file your 2008 return and pay any tax due by March 2, 2009, to avoid an estimated tax penalty.

Social Security, Medicare, and withheld income tax. If the monthly deposit rule applies, deposit the tax for payments in December 2008.

Nonpayroll withholding. If the monthly deposit rule applies, deposit the tax for payments in December 2008.

January 16

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on January 10-13.

January 23

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on January 14-16.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on January 17-20.