Can Corporate Tax Reform Build on Apple’s Proposal?

Treaty Relief for Unregulated Investment Funds?

The Dubious Distinction Between Politics and Charity

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Transfers of Intangibles to an Existing Partnership

Limited Scope Tax Engagements Are Not as Limited as You Think
Celebrity Doppelgängers

Tax wonks are all celebrities in our eyes, but some of our favorite tax practitioners happen to bear a striking resemblance to other people in the public eye.

Michael Danilack
PwC

Wolf Blitzer
CNN

Douglas O’Donnell
IRS

Farmer
American Gothic

Helen Morrison
EY

Sigourney Weaver
Alien

Brian Jenn
Treasury

Topher Grace
That ’70s Show

Mark Perwien
IRS

J. K. Simmons
Law & Order

Marjorie Rollinson
IRS

Sen. Elizabeth Warren
D-Mass.

Steven Musher
IRS

Lyle Lovett
singer-songwriter

Christopher Rizek
Caplin & Drysdale

Cary Grant
An Affair to Remember

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Corporate Tax Reform for All

By Ariel S. Greenblum —
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Comprehensive tax reform will not happen in 2016, according to a survey of business tax executives conducted by Miller & Chevalier Chtd. and the National Foreign Trade Council, Dylan Moroses reports (p. 38). If and when it does eventually happen (and 11 percent of those surveyed believe it never will), respondents are already disappointed with it because they believe that Congress won’t lower the corporate and individual rates far enough.

The conflation of tax reform and rate cutting is not new, but the study is a disheartening example of how deep that misconception runs. The overwhelming majority of respondents prioritized decreased rates over code simplification and revenue neutrality, Moroses says.

The definition of tax reform is many things, including perhaps cutting rates. But despite a lot of discussion in Congress, its goals remain polarizing, and the survey results rightly point to the dismal chances of reform being achieved with a divided government. If only there were a compromise.

Apple Inc. proposed one that would apply to corporate tax laws, and Bill Parks analyzes its call to eliminate all corporate tax expenditures, be revenue neutral, and impose a “reasonable” tax on foreign earnings, besides lowering the corporate rate and simplifying the code (p. 93). Apple’s proposal would make sense for the fisc and would make businesses happy because it changes the definition of corporate income, from one that applies credits and deductions, to one that uses book income, or revenue less expenses, Parks says. Higher corporate income across the board would allow for lower rates, he writes. It’s a bold proposal, but with one of the biggest corporate players in the world already behind it, maybe others will follow.

Using sales and income figures from financial statements to determine jurisdictions’ shares of taxable income, just as the states do, is in line with Apple’s goal of imposing reasonable foreign rates, Parks says. Sales factor apportionment may not satisfy political liberals who want to use worldwide income as the tax base, but it could be used to distinguish between domestic and foreign profits, he adds.

House Speaker Paul D. Ryan is undoubtedly an influential person in tax (and according to the survey, the most influential). He recently talked about expanding everyone’s slice of the economic pie but emphasized that the government should not redistribute slices (p. 40). Parks says that what Ryan is truly after is tax relief and, by accomplishing that, Apple’s ideas could be ripe for breaking the gridlock.

Highlights

The D.C. Circuit in Validus held against the IRS on its application of the foreign insurance excise tax, using logic that revealed the court’s unfamiliarity with tax law, Jasper Cummings, Jr. says (p. 65). The court held that because Congress did not clearly indicate its intent to tax beyond the territory of the United States, the presumption against extraterritoriality should limit the tax’s reach, he writes. According to Cummings, it’s an odd conclusion, given that the whole point of the tax is to have extraterritorial effect. But he admits that he is in the minority and he said most commentators believe the D.C. Circuit got it right.

Tax attorneys often want to limit the scope of client representation to specific years or particular transactions under audit. However, when things go awry, courts can overrule those limitations and find that the attorneys’ duties to their clients extended further than they anticipated, say Scott Hessell and Erin Wolf (p. 87). The key to avoiding that situation is to include representation limitations upfront in the written retention agreement, the authors say. However, Hessell and Wolf discuss cautionary tales of attorneys who lost malpractice cases because of flawed agreements with inadequate limitations provisions, and they describe the pitfalls to watch out for.
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NEWS AND ANALYSIS

TREATY RELIEF FOR UNREGULATED INVESTMENT FUNDS?

By Lee A. Sheppard — lees@taxanalysts.org

Yahoo Inc. has been a big subject of discussion in these pages for its failed spinoff, which earned CEO Marissa Mayer a place in the 2015 International Tax Review 50 for the year’s biggest tax blooper. Yahoo recalibrated and announced that it would spin off its core business — whatever that is — instead of its Alibaba Group investment.

What core business? Does Yahoo even have a business left? Yahoo’s business model may have been eclipsed over time anyway, but years of meddling by hedge fund investors did not help. Incredible as it seems now, the company refused a $45 billion purchase offer from Microsoft Corp. in 2008. Now Yahoo is shopping itself to everyone from private equity to phone companies.

A hedge fund installed Mayer in the first place. She began her disastrous reign by telling employees who worked at home — presumably including mothers of young children like herself — that they had to come to the office. Then she did a Vogue shoot, posing provocatively in expensive dresses. If only the earnings were as glamorous!

Yahoo’s basic business is shrinking, but its earnings per share were flattered by recent buybacks. Then again, buybacks might make sense for a company that is essentially in liquidation mode. Yahoo’s share price is 30 percent lower than it was 15 months ago.

Now another hedge fund, which owns roughly 2 percent of Yahoo, has begun a proxy contest to replace Yahoo’s entire board, including Mayer, with the aim of merging it with AOL Inc., another moribund walled garden of Internet search and email for unsophisticated users. La Cucaracha, as AOL is nicknamed, happens to own The Huffington Post. But other than that, it’s not clear what AOL’s business is either, or what a merger with Yahoo would accomplish. Yahoo responded by filling two board vacancies without talking to investors.

The moral of the story is that investment fund managers can sometimes be, as the British would say, too clever by half. They turn out not to be that good at running the companies they criticize or take over. Yahoo’s tormentor dismantled the board of the proprietor of Olive Garden just as middle-class restaurant patronage hit the wall. Maybe if the breadstick munchers could be persuaded to do all their searches on Yahoo... Fund managers have been too clever by half in tax and regulatory matters as well. They’ve argued that governments should trust them even though they’ve set themselves up in tax and banking haven arrangements that would suggest that they should not be trusted.

Unregulated investment funds don’t want regulation, but they want access to the institutional money and retail investors for which regulation is warranted. Investment fund managers don’t want to pay taxes or subject their investors to taxes. But they want their investors not to be inconvenienced by withholding taxes. Investment funds want anonymity for their investors. But they want withholding tax refunds for them too. They want treaty benefits for their investors without doing anything to prove they are deserving.

Except, of course, being large and controlling vast amounts of investment capital that gives them political sway in world financial capitals. When we last discussed investment fund whinges about treaty benefits and apparent tightening of treaty abuse concepts in the OECD’s base erosion and profit-shifting project, we saw officials empathizing but having difficulty fitting funds within the accepted rules. (Prior analysis: Tax Notes, Feb. 9, 2015, p. 732.)

Now the OECD has put out a consultation about how to accommodate unregulated investment funds with treaty benefits. This call for comments comes on top of treaty commentary calling for recognition of regulated investment funds as treaty residents of the countries in which they are organized. Are unregulated investment funds any closer to treaty relief? Only if they manage to construct a narrative that makes tax administrators feel better about recommending it.

A parallel worry for unregulated investment funds is treaty relief for dividends and entitlement to the benefits of the EU parent-subsidiary directive, 2011/16/EU. Substance requirements inspired by the BEPS project and put into practice in the form of recent amendments to the parent-subsidiary directive and the proposed EU anti-avoidance directive, COM(2016) 26 final, are
creating real problems for the business model of unregulated investment funds.

Treaty Relief

Basically, unregulated investment funds are asking for the same treatment as regulated investment funds, which are theoretically eligible for treaty withholding relief as beneficial owners of investment income. Regulated funds are perceived as deserving because they are regulated, diversified, widely held by ordinary citizens in their country of organization, and file tax returns. The OECD’s TRACE project was modeled on the U.S. qualified intermediary program in that investor information would be bottled up at the intermediary level and not passed on to governments except in cases of an information request (2010 OECD report, “The Granting of Treaty Benefits With Respect to the Income of Collective Investment Vehicles”).

The project was translated into extensive additions to the OECD model commentary recommending that regulated investment funds be treated as beneficial owners and treaty residents on their own ( paras. 6.8 to 6.34 of the OECD model commentary on article 1). The draft treaty language in the commentary leaves room for competent authorities to grant treaty benefits to unregulated investment funds (para. 6.17). But given that regulated investment funds, many of which are large and visible, aren’t getting much relief, the case for discretionary relief for unregulated funds appears weak.

The regulatory and enforcement justification for treating regulated funds as treaty residents doesn’t apply to unregulated funds, which have flitted in and out of countries where they invest without filing returns or paying tax on capital gains. They have done everything possible to escape the jurisdiction of the countries where their mind and management is, and everything possible to keep their investor lists secret from the governments of those countries. The countries where these funds are organized and tax resident are flags of convenience that maintain a veneer of regulation for the protection of creditors, which do not include tax authorities.

Unregulated investment funds don’t have to be organized in any particular form. Fund feeders catering to U.S. investors are usually organized as partnerships. For this reason, the United States persuaded other OECD countries to agree to look through partnerships to permit treaty benefits for eligible partners (1999 OECD report “The Application of the OECD Model Tax Convention to Partnerships”).

Consistent with that report, the OECD amended commentary to article 1 of the model treaty to say that the entitlement to treaty benefits should be determined by looking through to the investors in a transparent entity (paras. 2-6 of the commentary on article 1). The commentary advises source countries to look through tax haven partnerships to their treaty-country investors to grant treaty benefits (para. 6.5). The source country should be treating investors as though they earned the income items directly. Nonetheless, funds are unable or unwilling to give investor information to source countries. (Prior analysis: Tax Notes, Dec. 22, 2014, p. 1309.)

Unregulated investment funds organized as passthroughs can’t prove that they are residents of the jurisdictions in which they are organized and can’t or won’t indentify their owners. The consultation document recognizes those problems and
puts the onus on fund representatives to address them. Commentators suggested as an alternative proof of substantial connection to the country of claimed residence, which did not get a warm reception because it would still permit treaty shopping.

Substantial connection would be defined according to Dutch standards of residence for intermediary companies. The Dutch standard for substance is contained in two decrees that exalt job creation for Dutch professional service providers over actual substance. Half the entity’s board members must be Dutch residents qualified to do their jobs, and board meetings must be held in the Netherlands. The entity must have staff at its disposal — with no requirement that they be resident or employees. Bank accounts and bookkeeping have to be Dutch. The entity cannot be a dual resident and should have €2 million equity.

U.S.-managed fund feeders catering to foreign investors and tax-exempt investors are usually organized as companies to spare them from U.S. effectively connected income and debt-financed income, respectively. Tax haven corporations, by definition, are not eligible for treaty relief anywhere unless the haven is Ireland or Luxembourg. Why do U.S. funds insist on using the Cayman Islands? Because it has fund-friendly laws and infrastructure, and it is easily reachable from New York. Readers, the whole treaty relief argument is about the convenience of New York fund managers.

Moreover, deferral is not on the OECD’s list of desirable attributes prompting sympathy for investors. The consultation document wants to prevent both tax avoidance by investors not entitled to treaty relief and deferral on the part of those who are. Hedge funds, private equity funds, and even socially deserving venture capital funds hang onto investors’ money for a long time, and some make no current distributions. The consultation document asks for proof of investor taxation on undistributed income.

Regulated investment companies, in contrast, may be legally required to distribute all their income (e.g., section 852). The consultation document’s proposed elective global-streamed regime would require current distributions. Along the lines of the EU savings directive, 2008/48/EC, the proposal contemplates collection by the investor’s country of residence and remittance of tax proceeds to the country that is the source of the income or gain. This would be extremely clumsy outside the EU even if funds were able to qualify for it.

The best argument that the unregulated funds have is that the bulk of their investors are institutions in treaty countries, and the OECD BEPS negotiators are willing to give treaty benefits to pension funds, which do invest in unregulated funds (see, e.g., article 22(2)(e) of the 2016 U.S. model treaty). Following through on this argument would still require providing investor information to source countries. But the consultation document worries about long chains of ownership, which are typical, and taxable investors tagging along for the ride.

**Substance Requirements**

As previously noted, the outlook for holding companies in Europe is bleak. But it is bleaker for the kind of hollow entities used by investment funds. At the opposite end of the scale is that certain local activities undertaken by investment funds could create a permanent establishment.

BEPS discussions usually conjure thoughts of multinationals that produce physical products or sell services to identifiable market countries. No personnel in that stripped-risk distributor? That Swiss principal company is being managed out of Omaha and not Zug? Move some people! For the very largest groups, substance requirements are unlikely to be a barrier.

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'It is very difficult for pure passive holding companies to survive,' said Collet.

For them, showing substance to newly empowered European tax administrators is a matter of moving bodies around or reassigning the bodies already in the suspect location. These giants can also reassign activities. Group finance and intellectual property management can be put in holding companies, as the discussion showed at the recent International Bar Association annual conference on current international tax issues in cross-border corporate finance and capital markets in London.

"It is very difficult for pure passive holding companies to survive," said Michel Collet of CMS Bureau Francis Lefebvre in London.

Unregulated investment funds have an intractable problem. They often have a number of entities between investors and investments for the purpose of avoiding capital gains and withholding taxes, and ensuring entitlement to dividend exemptions. Many of these entities, set up in tax havens, have no personnel or premises. Nor can they possibly have them, given that every private equity acquisition has its own clump of entities.

Many of these entities are in Luxembourg, a fund-favoring jurisdiction that appears to be the last place on earth anyone wants to put personnel. In the case of a private equity fund, there would be no business managers in Luxembourg, and the local managers of the portfolio companies would not be
part of the chain of ownership. That leaves only back-office personnel eligible for Luxembourg duty. Would that be enough? It depends on the tax authority. For the French, yes. For the Danes, no.

Discussions at the recent annual conference on tax planning strategies for the United States and Europe hosted by the American Bar Association, International Fiscal Association, and IBA in Milan reached some conclusions. Put some bodies in the Luxembourg entities. Try to have a nontax business reason for each of them. Think about consolidating the entities for many investments into a single master holding company with substance. It might be better to fund acquisitions with third-party debt instead of shareholder debt.

In a private equity acquisition of a target company in an EU country, there can be as many as four hollow entities between the investment fund and the target. The entities closest to the investors are in a tax haven like the Cayman Islands, the Netherlands, or Luxembourg. The entities closest to the target are in its country of residence.

What do they all do? The acquisition or bidding company, which acquires the shares of the target directly, is in the target’s home country. Above it, there may be a home country holding company that does the acquisition borrowing. The holding company or acquisition company is owned by a Dutch BV or Luxembourg SARL. The BV or SARL would be owned by a Dutch co-op or another Luxembourg SARL, respectively, that is owned by the fund. The Dutch entities are passthroughs. The Luxembourg entities are opaque and checked, and also financed with hybrid debt, private equity certificates (PECs), or convertible private equity certificates (CPECs).

None of these entities, a set of which exists for every deal, would usually have any substance. They automatically pay interest or dividends received to the next level. Local managers run the target companies, but they have no connection to the ownership or the investment managers who tell them what to do.


The parent-subsidiary directive’s prescription for a common minimum antiabuse rule permits EU member countries to adopt a safe harbor. The amended directive commands that the benefits of the directive not be granted to arrangements that have as a main purpose obtaining a tax advantage that defeats the objects of the directive. It excuses arrangements that have valid commercial reasons that reflect economic reality (16633/14). The concepts are similar to the proposed EU antiavoidance directive (COM(2016) 26).

As vague as that wording appears, the point is that the payee have substance and be the beneficial owner of the dividend for the payer’s country of residence to grant withholding relief under the directive. The preamble to the amendment counsels that when faced with a multistep arrangement, tax administrators can attack the hokey part and leave the genuine part alone. That means that even if the entities have substance, the tax administrator can deny benefits when the payee is not the beneficial owner of the dividend payment.

In Milan, Nikolaj Bjørnholm, a private practitioner, commented that in analyzing eligibility for exemption from withholding under the parent-subsidiary directive, Denmark looks for the recipient’s obligation to pass on the payment. The tax authorities require withholding on payments to entities that they consider conduits. The question rattled through the Danish courts, which have recently referred questions to the Court of Justice of the European Union. The Danish Ministry of Taxation has admitted that the beneficial ownership rules conflict with freedom of establishment.

Andrea Silvestri of Bonelli Erede Pappalardo explained that Italy employs a substance test to determine eligibility for exemption from withholding under the parent-subsidiary directive when the payer of a dividend is ultimately owned by a non-EU resident. The burden is on the taxpayer to demonstrate the main purpose of the arrangement. Italy also has an administrative practice for beneficial ownership, and the arrangement may be challenged. If the payee automatically distributes the dividend, that may belie beneficial ownership, Silvestri noted. (Prior analysis: Tax Notes Int’l, Dec. 23, 2013, p. 1133.)

Albert Collado of Garrigues explained that the Spanish treatment is similar to the Italian treatment. Before the 2015 Spanish tax reform, no exemption from withholding under the parent-subsidiary directive was available when the payer of a dividend is directly or indirectly controlled by a non-EU resident; unless the parent carried on a business related to the subsidiary’s business in Spain; or the parent managed the subsidiary using real human resources; or had a valid business reason for the arrangement. The tax authorities were very restrictive in their interpretation of the requirements. (See the Aromatics cases — Supreme Court, Apr. 4, 2012, Mar. 21, 2012, and Mar. 22, 2012; RHI case — National Appellate Court, Nov. 25, 2010; Pilbrico case — Asturias High Court, Apr. 11, 2011; and Enbridge case — National Appellate Court, June 3, 2015.)
The recent Enbridge decision affirmed that narrow interpretation, Collado observed. In that case, a Canadian company owned a Danish company that owned 25 percent of a Spanish company and had no other assets. The Danish company’s two employees were in Spain and Colombia. There was no substance in Denmark and no purpose for the company’s formation. Therefore the benefit of the parent-subsidiary directive was denied. (Prior coverage: Tax Notes Int’l, May 9, 2011, p. 501.)

Spanish law was recently changed to accommodate owners with AIFMD licenses. Exemption from withholding under the parent-subsidiary directive is available when the EU resident owner owns at least 5 percent or has invested at least €20 million. Mirroring the EU parent-subsidiary directive, the Spanish implementing antiabuse rule would not apply when “the formation and operations of the recipient of the dividend or royalty are based on valid economic grounds and business reasons with substance.” The new Spanish law also introduced an antiabuse rule for royalties. (Prior analysis: Tax Notes Int’l, Sept. 29, 2014, p. 1112.)

An AIFMD license would help in the argument that there is a business reason for a holding company, but if it were in Luxembourg, substance would need to be demonstrated. Collado explained that is it not clear which entity must have substance — the Luxembourg vehicle closest to the Spanish acquisition, or perhaps a single Luxembourg holding company that had substance, servicing all of the fund’s portfolio companies. There is no Spanish guidance on what is required for substance.

If the arrangement does not qualify for the parent-subsidiary directive, it may also fall out of the pertinent treaty, should a general antiabuse rule as required by the proposed EU antiavoidance directive come into force, Collado warned. The current OECD model commentary states that domestic general antiabuse rules do not conflict with treaties and may be applied to treaty abuse when there is a main purpose to get benefits, which would conflict with the object and purpose of the treaty provision (paras. 22-27 of the model commentary on article 1).

“We’re all talking about BEPS action 6, but no one’s doing anything about it,” said Catherine Sear of Proskauer Rose London. Sear predicted that the United Kingdom would sign the principal purpose clause that will feature in the multilateral instrument.

Internal Finance

The biggest users of European holding companies are Americans. PECs and CPECs were created for them, and Americans love them. PECs and CPECs get equity treatment for U.S. tax purposes and debt treatment in Luxembourg despite their boatload of equity features. Theoretically, these hybrids could get banged up under the BEPS action 2 hybrid mismatch report.

“PECs are sacred,” Ayzo van Eysinga of Stibbe commented in London. Even if the antiavoidance directive becomes EU law, Luxembourg would only put it into force vis-à-vis EU entities. The target’s home country may deny an interest deduction, Sam Kaywood of Alston & Bird LLP noted, but there is no problem with equity treatment under U.S. law.

In a typical private equity setup, the target is likely to be paying current interest on straight debt to the same-country acquisition company, with which it may join in a combined return. The acquisition company issues PECs or CPECs to its Luxembourg owner. PECs or CPECs are issued all the way up the chain of Luxembourg entities, which are checked for U.S. tax purposes. So in the U.S. view, only the ultimate payee matters, and the payment is a dividend given the predominant equity features of PECs and CPECs.

Treaty-benefited dividends are not the whole rationale for the chain of entities. The investors want a handy entity that can be sold or liquidated when they want to monetize their investment the target. When the target is sold, the lower-tier Luxembourg SARL either liquidates into the upper-tier Luxembourg SARL or pays it a dividend, incurring no withholding either way. Kevin Keyes of KPMG LLP explained that for a partial exit, the parties repay the CPECs. The United States treats the repayment as a dividend out of the CPEC issuer’s earnings and profits.

Keyes explained that if the acquisition company were in the same jurisdiction as the target company, a direct shareholder loan from the former to the latter should not be used if equity treatment for U.S. purposes could not be achieved under the local country law. In these cases, a separate finance company organized in Luxembourg to issue CPECs to the fund could be considered. The acquisition company would issue the shareholder loan to the finance company, which would issue the CPECs to the fund or its holding company.

Some countries have listing exceptions to withholding on interest. The United Kingdom would withhold on interest payments unless the debt is listed, so funds typically list on a Channel Islands exchange. Otherwise, the finance company should be located in a treaty jurisdiction to be eligible for reduced withholding, Keyes advised. There will inevitably be questions whether the finance company is the beneficial owner of interest payments it receives.

Silvestri explained that Italy requires that the finance company be the beneficial owner of the
interest payments it receives. Under Italian beneficial ownership guidance, a beneficial owner must achieve an economic benefit from the transaction; must have legal title and access to the income; and must have adequate structure and ability to manage its financial risks. There is no guidance on the first element, the amount of spread, which would be a transfer pricing question. But the finance company should be able to manage its financial risks and should not pay the interest income over to its owners too quickly, according to Silvestri.

An unpublished Italian tax ruling was issued for a French special purpose vehicle (SPV) that owned EU subsidiaries, which it financed with bank loans and debt sales. It had no employees, but it was part of a larger group that had employees. The loans between the French SPV and the subsidiaries did not have commercial terms, that is, the terms did not mirror those of the third-party loans to the SPV. An Italian subsidiary borrower did not guarantee the third-party loans. Taking a very strict approach, the tax authorities used those factors to deny beneficial ownership, emphasizing the absence of employees at the level of the French SPV.

Collado noted that in Spain, beneficial ownership is not a concept of the law, but tax authorities do raise it to challenge some back-to-back structures. Spain is one country that asserts the right to tax gains on shares issued by its companies, and, as Collado described, bonds issued to finance Spanish assets. In a tax ruling he called scary, Spanish tax authorities asserted the right to tax bonds issued by a Dutch issuer on a Dutch platform but used to finance Spanish assets. There was no beneficial ownership under Spanish law, the argument having lost in court.

**Distressed Debt Buying**

Everything in Europe is for sale. And many European lenders — which, unlike U.S. lenders, really do lend to businesses — have books full of garbage loans that they want to sell to investors. What happens when investment funds buy pools of dodgy loans from their originators, then try to work them out with same-country borrowers?

What if the fund takes equity in the borrowers? Does such a fund have a dependent agent PE in the country? In the United States, the IRS has made its views on private investment in public equity (PIPE) funds clear (ILM 201501013). Keyes noted that debt funds are now using special purpose Irish entities to purchase and work out debt, so that they could have the advantages of the treaty in the event there is a dependent agent PE. (Prior analysis: Tax Notes, Jan. 19, 2015, p. 298.)

If the fund is buying its dodgy debts in the United Kingdom, it can rely on the investment management exemption and the Luxembourg treaty — unless it plans to work out the debts, in which case that would fall into the category of trading and create a PE. As in U.S. law, only passive investors are excused from being in a trade or business (section 864(b)(2)(A)(iii)). In the United Kingdom, lending can be conducted through an independent agent without the nonresident lender being liable subject to tax (section 127, Finance Act 1995; section 148(3)/Schedule 26, Finance Act 2003; and HMRC Statement of Practice 1/01).

Italy recently enacted laws to help banks get rid of their bad loans, but those laws focus on the sellers and not the nonresident purchasers (Law Decree 91). Investment funds can now lend into Italy without tax obstacles, but activities on the ground still raise questions. Local servicing of distressed loans would create a dependent agent PE in Italy. Therefore, according to Silvestri, debt investors should go into Italy using a SPV that is not organized in a blacklisted tax haven like the Caymans. Ireland would be acceptable for that purpose. (Prior analysis: Tax Notes Int’l, Aug. 11, 2014, p. 447.)

Working out a debt would also create a PE in Spain, making all associated interest and gain taxable, according to Collado. Moreover, once a PE is created, every asset it holds is part of the PE. The Spanish tax authorities and courts have been very active in using the PE concept to generate nexus in Spain, so investors must consider this in planning debt portfolio investments.

Funds generally use Luxembourg or Irish vehicles to buy debts in Spain, so that interest is exempt from withholding when the payee is an EU resident. Spanish law permits specialized funds to invest in debt portfolios, which are taxed at a corporate rate of 1 percent. However, investors must factor in Spain’s domestic withholding tax on interest, which, although it is recoverable, is an additional financial cost, Collado explained.

**Manager Compensation**

What about the part that really matters to the managers — the top of the fund? After hammering citizens with unnecessary austerity and corporate income tax cuts, the British Conservative government is doing something about lightly taxed investment fund manager compensation. You have to hand it to those upper-class dilettantes — all that time spent in the country enables them to recognize a pitchfork when they see one.

Under the latest budget, carried interest — British managers borrow to purchase real capital interests in their fund — is taxed as ordinary income unless it is subject to a hurdle rate. All income from trading or lending is taxed at the ordinary rate of 47 percent to prevent recharacterization as carried interest. If the general partner waived fees, amounts received will be tested to see if they were received...
for services. In a separate change, capital gains from proceeds of sales will be taxed at 28 percent, which is higher than the normal capital gains rate.

Populism is raising its head in the usually tone-deaf American political system, and presidential candidates from both parties have said they would tax profits interests as ordinary income. Profits interests are income strips. Unlike British managers, American managers do not invest their own or anyone else’s capital to support them. Investors shift 20 percent of the profits of a typical fund to the managers, which has the effect of a deduction even for tax-exempt investors.

Even Senate Finance Committee member Charles E. Schumer, D-N.Y., who represents the financier class, now supports ordinary treatment of profits interests for as many industries as possible, which is code for exempting real estate. It’s a quick and easy way to be seen as caring about fairness while hitting a generally despised class of financiers.

Ordinary treatment of profits interests is a quick and easy way to be seen as caring about fairness while hitting a generally despised class of financiers.

Fund managers accept that enactment of legislation, which has been kicking around for a decade, is inevitable. There are two competing bills ready to be enacted. The older version, introduced by House Ways and Means Committee ranking minority member Sander M. Levin, D-Mich., would treat all income and gain on profits interests as ordinary, and would fence off losses from use against other income. Service partners would be treated as partners on their own capital investments in the fund (Carried Interest Fairness Act of 2015, H.R. 2889 and S. 1686).

The newer version is contained in the extensive tax reform draft released by then-Ways and Means Committee Chair Dave Camp. This version would impute interest income to the service partner on a deemed loan of the capital that supports the profits interest. To the extent that it exceeds that imputed interest, the service partner’s net capital gain, whether allocated or from disposition of his interest, would be treated as ordinary. It’s more convoluted than this capsule description because the service partner would have a running account balance for recharacterization. (Prior analysis: Tax Notes, Mar. 10, 2014, p. 1137.)

TAX HISTORY

The Dubious Distinction Between Politics and Charity

By Joseph J. Thorndike — joseph.thorndike@taxanalysts.org

A few months ago, Facebook founder Mark Zuckerberg and his wife, Priscilla Chan, made headlines with an outsized venture into “hacker philanthropy.” Announcing plans to donate 99 percent of their Facebook stock over the course of their lifetimes to a new charitable venture, they established the Chan Zuckerberg Initiative, a limited liability company that “seeks to advance human potential and promote equality.”

The gift was notable for its size: roughly $45 billion, based on share prices when the gift was made. But it was also striking for its vehicle. According to the couple, the use of an LLC would allow greater flexibility in pursuing philanthropic goals. “This enables us to pursue our mission by funding nonprofit organizations, making private investments and participating in policy debates — in each case with the goal of generating a positive impact in areas of great need,” they wrote.

Every element of this flexibility raised eyebrows — some admiring, others critical. But the intention to engage in “policy debates” got special attention, probably because political action is a hallmark of the hacker philanthropy movement. As Napster co-founder Sean Parker wrote to his fellow young philanthropists in The Wall Street Journal last June, “political interventions might seem dirty, with the potential to sully your reputation, but many of our big problems have a political dimension.”

‘Political interventions might seem dirty, but many of our big problems have a political dimension,’ Parker wrote.

In recent years, the intersection of politics and charity has been frequently in the spotlight, thanks to the section 501(c)(4) controversy. But in fact, the issue is an ancient one by tax standards. Since at least the early 20th century, Americans have been struggling to define the proper relationship between philanthropy and politics. In particular, they have been engaged in a long-running — not to mention problematic and unsuccessful — effort to keep the two separate, at least when it comes to taxation.
**Probate Courts**

The line between politics and charity has always been disputed, never less than when it was first created. Olivier Zunz, a political and business historian at the University of Virginia, has outlined the argument in his 2012 book, *Philanthropy in America: A History*. Zunz argued that courts, lawmakers, and executive branch officials have “built an often arbitrary divide between a political-neutral field of ‘education,’ which they allow to philanthropy, and political ‘action,’ which is off limits.”

Zunz begins his story in the 19th century, when probate courts were the principal venue for arguments about charity and politics. American law had traditionally tried to protect heirs from the generous instincts of their decedents. Charitable bequests had to be limited and specific, and heirs had considerable success in challenging gifts that didn’t meet those requirements.

Eventually, however, both donors and social reformers began to realize the potential inherent in large fortunes. “Much common ground was found in the recognition that the large newly available philanthropic resources should not go directly to the poor,” Zunz said of the developing alliance. “Instead these resources were to be treated as public assets, making it possible to address large questions of social organization.”

Gradually, courts began to loosen the strictures on bequests, giving donors more flexibility in how they disposed of their assets. In particular, judges began to make room for political activity — in a way that later courts and Treasury regulators would not. The decisions of the era “are very instructive of the arcane ways judges, when free from issues of taxation, in effect recognized the indissoluble combination of giving and advocacy,” Zunz observed.

Gifts were sometimes contested in probate court by angry heirs insisting that donations were too overtly political, and judges were sometimes inclined to agree. But increasingly they declined to draw bright lines. “Financing of a political campaign, even when the ultimate goal was to change the law, was permissible, but only if the funds were allocated for the education of the public and not for direct lobbying of those in a position to act,” Zunz wrote. In other words, politically engaged giving was permissible as long “as it did not technically encroach upon the territory of formal politics.”

Ultimately, the courts developed a position that was more permissive than Treasury would later adopt when regulating charities in the age of the income tax. Zunz suggested that this was perhaps because judges were defending the interests of grasping heirs in their struggle against generous decedents — a less compelling responsibility than Treasury’s later responsibility to protect the fisc from aggressive tax avoiders.

**Early Exemption**

The arrival of the income tax changed everything. The first federal exemption for charitable entities appeared in the 1894 income tax, which the Supreme Court found to be unconstitutional before it was ever collected. The exemption reappeared in the Revenue Act of 1909, which imposed a new excise tax on corporate profits but exempted entities “organized or operated exclusively for religious, charitable or educational” purposes. When Congress took another stab at the income tax in 1913, it left the exemption more or less intact.

In 1917 lawmakers added a deduction for charitable gifts, for the first time adding individual incentives to the philanthropic mix. “Personal deductions encouraged a great many more Americans to participate in philanthropy, and so became an important factor in the success of mass philanthropy,” Zunz wrote.

As the income tax grew, so did the expense of the exemption and the deduction. Predictably, lawmakers and Treasury officials set about trying to narrow its scope. Zunz drew special attention to a 1919 Treasury regulation that attempted to limit the political activity of exempt organizations. “Associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute,” Treasury declared.

And that was only the beginning. The Board of Tax Appeals, the forerunner of today’s Tax Court, joined the battle to limit political activity. “The compromise rulings of the probate courts, premised on broad definitions of charity and judicial discretion, were no longer acceptable models,” Zunz wrote. “The mere intention of being charitable was not enough.” Treasury’s restriction on “controversial or partisan propaganda” took on a sharper edge, partly in a bid to protect the government’s revenue, but also as a matter of principle. “By using exemption as a tool to regulate charity, Treasury officials sharpened the distinction between knowledge and advocacy, which judges had left vague,” Zunz wrote.

Some rulings of the board seem puzzling, especially in retrospect. The board denied exemption, for instance, to the League to Enforce Peace, a group founded in 1915 to support international bodies like the League of Nations. The board found the group’s
activities — especially after American entry in World War I — to be overtly political rather than simply educational. The board also denied exemption to the North American Civic League for Immigrants, the Scientific Temperance Federation, the Massachusetts Anti-Saloon League, and the Massachusetts Anti-Cigarette League. In each case, the argument hinged on whether the group was in the business of disseminating “controversial or partisan propaganda.”

Often the real issue (both for the board and for Treasury) was not a group’s activities but the nature of its policy focus. If a subject was politically contentious — as with temperance, for instance, or immigration or the creation of the League of Nations — almost any activity in support of that issue could be cast as controversial or propagandistic. Only the most anodyne of issues was safe from challenge. “By the late 1920s, the Treasury Department was set on making the tax exemption available only to those donors committed to helping noncontroversial educational causes that could not be construed as remotely political or even merely ideological,” Zunz concluded.

Birth Control

The problematic line between education and advocacy was especially visible in decisions around the birth control movement. The topic was highly contentious during the 1920s and 1930s, as activists like Margaret Sanger challenged social mores, as well as legal structures, on the dissemination of information about birth control. In many states, this material was considered obscene. Sanger and her allies were determined to change the obscenity laws, and they forged a diverse coalition in support of their agenda.

The Birth Control League lost its exemption when the Second Circuit held that the group was engaging in overt political activity.

But Sanger had problems with the tax law. In 1930 her organization, the Birth Control League, lost its exemption when the Second Circuit upheld a decision of the Board of Tax Appeals finding that the group was engaging in overt political activity. In his decision in Slee v. Commissioner, Judge Learned Hand expressed real sympathy for the league and its mission. But sympathy was not enough. The organization’s purposes “cannot be said to be ‘exclusively’ charitable, educational or scientific,” he wrote.

It may indeed be for the best interests of any community voluntarily to control the procreation of children, but the question before us is whether the statute covers efforts to proselytize in that or other causes. Of the purposes it defines “educational” comes the closest, and when people organize to secure the more general acceptance of beliefs which they think beneficial to the community at large, it is common enough to say that the public must be “educated” to their views. In a sense that is indeed true, but it would be a perversion to stretch the meaning of the statute to such cases; they are indistinguishable from societies to promote or defeat prohibition, to adhere to the League of Nations, to increase the Navy, or any other of the many causes in which ardent persons engage.

Hand seemed to recognize that distinctions between education and advocacy were hard to draw clearly. “There are many charitable, literary and scientific ventures that as an incident to their success require changes in the law,” he acknowledged.

A charity may need a special charter allowing it to receive larger gifts than the general laws allow. It would be strained to say that for this reason it became less exclusively charitable, though much might have to be done to convince legislators. A society to prevent cruelty to children, or animals, needs the positive support of law to accomplish its ends. It must have power to coerce parents and owners, and it does not lose its character when it seeks to strengthen its arm. A state university is constantly trying to get appropriations from the Legislature; for all that, it seems to us still an exclusively educational institution.

Indeed, charitable groups deserved considerable latitude in advocating for specific issues, he found, writing:

We should not think that a society of booklovers or scientists was less “literary” or “scientific,” if it took part in agitation to relax the taboos upon works of dubious propriety, or to put scientific instruments upon the free lists. All such activities are mediate to the primary purpose, and would not, we should think, unclass the promotors. The agitation is ancillary to the end in chief, which remains the exclusive purpose of the association.

Nonetheless, Hand found that the Birth Control League had crossed a line separating permissible advocacy from political agitation. His reasoning was strained, but it was just as clearly consistent with the legislative, regulatory, and judicial history.
of the issue. Moreover, as Zunz pointed out, Hand believed deeply in the distinction between education and advocacy, no matter how hard it was to define. Like others of his day, Hand believed in the value of expertise and disinterested, “scientific” knowledge. Insulating that knowledge — and the educational efforts that bolstered it — from political activity was crucial, even when it was difficult to do.

Power Struggles

Ultimately, however, many arguments over tax exemption were less high-minded than the one Hand offered in his decision. Frequently, in fact, exemption law was a matter of raw politics. To illustrate, Zunz took a close look at the Revenue Act of 1934, which made the distinction between education and advocacy a matter of statutory law.

The story hinges on a battle between veterans and budget hawks. In particular, it pitted the American Legion against the National Economy League, a tax-exempt organization established to advance the cause of budgetary restraint. In the early years of the Great Depression, the league targeted veterans’ benefits for severe cuts, arguing that the country could no longer afford them. But in the ensuing battle, the American Legion attacked the league as simply a stalking horse for conservative activists.

“Your purpose is to influence legislation,” complained one senator when speaking to a representative of the league. If true, that charge would have endangered the league’s exempt status. But the league’s leadership was quick to object. “Our purpose is to get the facts before the people, and I believe they will influence legislation,” insisted the group’s director.

Veterans and their congressional champions continued to pursue the exemption issue, proposing new legislation to restrict the political activity of most exempt organizations. The target of the change was clear. “There is no reason in the world why a contribution made to the National Economy League should be deductible as if it were a charitable contribution,” declared Sen. David Reed on the Senate floor. The gift was actually “a selfish one made to advance the interests of the giver of the money.”

Lawmakers eventually agreed, adding language to the Revenue Act of 1934 requiring that EOs devote “no substantial part” of their activities to “carrying on propaganda, or otherwise attempting, to influence legislation.”

Notably, however, this language did not apply to all exempt organizations. Groups with special exemptions in the law, including veterans organizations, fraternal groups, and labor unions, remained free of the new anti-propaganda language. For Zunz, this was crucial. “Congress made for the first time a distinction that has become increasingly important between different kinds of exempt groups, a distinction that reflected political muscle more than logical categorization,” he wrote.

Indeed, the history of the 1934 change illustrates the way that exemption restrictions can be weaponized, Zunz concluded. Interest groups of the era “saw the removal of tax exemption as a tool to silence their opponents.”

Ultimately, Zunz tells a valuable, if sobering, story — and one with obvious relevance for contemporary critics of the way tax law treats EOs. The desire to shield charity from politics is understandable. It seems wrong for the government to be able to subvert political activity through an exemption or deduction. But trying to draw the right line is a difficult, perhaps hopeless, task. “It is remarkable how much effort lawmakers, regulators, and philanthropists alike have invested throughout the twentieth century in the nearly impossible task of maintaining a solid distinction between philanthropy and politics,” Zunz concluded.

Interest groups of the era ‘saw the removal of tax exemption as a tool to silence their opponents,’ Zunz wrote.

It’s hard not to wonder: Is the distinction between education and advocacy really viable?

At best, efforts to draw a bright line end up being high-minded but arbitrary. At worst, they become just another front in the battle among interest groups.

Maybe it’s time to toss in the towel.
Starr Forgoes Appeal, Opt To Pursue Claim Under APA

By Matthew R. Madara — mattr.madara@taxanalysts.org

Starr International Co. on March 24 filed an amended complaint seeking judicial review under the Administrative Procedure Act (APA) following a February decision by the U.S. District Court for the District of Columbia that monetary relief was not available to the Swiss-domiciled company.

Starr, a former shareholder of American International Group Inc., is seeking a refund under the Switzerland-U.S. tax treaty of $38 million in withholding on dividends received from AIG in 2007.

The amended complaint alleges that the IRS improperly denied Starr’s request. Starr argued that the five reasons the IRS gave for denying treaty benefits were arbitrary, capricious, and an abuse of discretion because “obtaining benefits under the treaty was not a principal purpose of moving [its] residence from Ireland to Switzerland, but instead its owners had substantial reasons for moving that were unrelated to obtaining treaty benefits.”

Patrick J. Smith of Ivins, Phillips & Barker Chtd. said an interesting detail included in the amended complaint is an allegation that the IRS acted in bad faith because the former deputy commissioner with the IRS Large Business and International Division responsible for denying the treaty benefits request told a Starr representative that “he intended to find a basis for denying” the company’s request.

The allegation that the deputy commissioner reached a decision without rationale and then found a basis to defend it “doesn’t sound like an appropriate position for an IRS official to be taking,” Smith said. That assertion appears “to be pretty powerful evidence in favor of the taxpayer’s position that the IRS acted arbitrarily and capriciously,” he said.

The litigation initially raised the question whether the U.S. competent authority’s exercise of discretion is subject to judicial review. In September 2015 the court determined in Starr International Co. v. United States, No. 1:14-cv-01593 (D.D.C. 2015), that it had the required authority after concluding that the government failed to demonstrate clear and

IRS CHANGES TUNE ABOUT HARD DRIVE IN MICROSOFT FOIA LITIGATION

The IRS has found a hard drive with retrievable information that belonged to Samuel Maruca, former transfer pricing director in the IRS Large Business and International Division, the Justice Department told the U.S. District Court for the Western District of Washington on March 25.

The admission that the hard drive was not “sanitized,” as the Justice Department asserted in January, is the latest twist in Microsoft Corp.’s ongoing Freedom of Information Act litigation (Microsoft v. IRS, No. 2:15-cv-00369; and Microsoft v. IRS, No. 2:15-cv-00850) with the IRS, which has recently drawn Congress’s attention. (Prior coverage: Tax Notes, Feb. 15, 2016, p. 762; and Tax Notes, June 8, 2015, p. 1134.)

In October 2015 the court ordered the IRS to “search for, process, and release” nonexempt records responsive to Microsoft’s FOIA requests. The Justice Department informed the court in January that Maruca’s hard drive had been sanitized in April 2015, despite a litigation hold instituted by the IRS Office of Chief Counsel. (Prior coverage: Tax Notes, Jan. 25, 2016, p. 398.)

Maruca was included on a list of individuals who might possess documents concerning the IRS’s contract with Quinn Emanuel Urquhart & Sullivan LLP when the company filed its first FOIA lawsuit in March 2015. Maruca left the IRS in August 2014, and the hard drive should have been recycled within 30 days under the IRS’s ordinary data management practices (CC-2012-17).

The latest Justice Department statement explains that the IRS has continued to look for responsive records to satisfy the court order. The statement says that potentially responsive documents from the hard drive were saved elsewhere in July 2014 before Maruca left the IRS. The IRS now says Maruca’s hard drive was not recycled in April 2015 and that it contains user-generated content. According to the Justice Department, the IRS is now processing the content in search of responsive records.

The FOIA litigation is closely connected with the company’s failed attempt to quash designated summonses issued against it in the ongoing transfer pricing audit of its 2004-2006 tax years. The Justice Department sued Microsoft to enforce the summonses after it failed to comply with them. Microsoft argued that enforcing the summonses would be an abuse of the court’s process because the IRS engaged Quinn Emanuel, a private firm, to assist in the summons process. (Prior coverage: Tax Notes, Nov. 30, 2015, p. 1128.)

— Matthew R. Madara
IRS Inconsistent in Denying Estate Tax Deduction for OVDP Penalty

By William Hoke — william.hoke@taxanalysts.org

By denying an estate tax deduction for the miscellaneous offshore voluntary disclosure program penalty for the estate of a woman who died in 2012, the IRS is acting contrary to its internal position on the issue, according to a lawyer involved in the case.

James Gifford, an associate with Anaford AG, filed a Freedom of Information Act request for documents related to the IRS’s previously undisclosed position on the issue. Milan Patel, a partner with the firm, said the agency’s position appears to have been formulated between 2013 and 2015. In a memo dated April 11, 2013, an unidentified IRS official expressed the agency’s “national position” that if no person other than the decedent “was cognizant of the existence of the offshore account, or participated in the movement of the funds offshore” before the estate tax return was filed, the IRS would allow the estate to deduct the OVDP penalties from the taxable gross estate. The official added, however, that if anyone other than the decedent (including family members, accountants, attorneys, or anyone else with a material interest) was “cognizant” of the account’s existence and the executor or personal representative failed to make a disclosure by the due date of the return, no reduction of the penalty against the estate’s value would be allowed.

Patel said that position was contradicted by two more recent internal memos sent by John McDougal, special trial attorney and division counsel, IRS Small Business and Self-Employed Division. In the first memo, dated November 17, 2014, McDougal said that “if the voluntary disclosure is made only on behalf of the decedent then the penalty is clearly deductible.” And in a memo dated March 9, 2015, McDougal said, “The law is clear that, if the estate uses estate funds to pay a debt of the decedent — even if the debt is for a fine or penalty — then the estate is entitled to a deduction against the gross estate.”

Patel said his firm’s client is the estate of a dual Swiss-U.S. citizen with U.S. residency who failed to make a voluntary disclosure before her death. The woman’s daughter filed the disclosure promptly after being named executrix and paid the penalty out of the estate’s assets, Patel said. The IRS audited the estate tax return and told Patel that it would not allow the penalty as an administrative deduction of the estate. That determination contradicts the IRS’s position as stated in McDougal’s two memos, Patel said.
Reg. section 20.2053-6(a)(1) states that in general, taxes are deductible in computing a decedent’s gross estate. Patel said penalties are considered taxes. Section 6671(a) says, “Except as otherwise provided, any reference in this title to ‘tax’ imposed by this title shall be deemed also to refer to the penalties and liabilities provided by this subchapter.”

**Auditor’s Position ‘Nonsensical’**

Patel said the IRS auditor’s position is nonsensical. He gave as an example a U.S. resident whose only assets consisted of an undisclosed offshore account valued at $5 million, which would be subject to a hypothetical OVDP penalty of $1 million. Patel said that assuming a 40 percent estate tax rate, no deductions for administering the estate, and no complications from state or foreign death taxes, if the individual paid the offshore penalty the day before dying, the estate would have a federal estate tax liability of $1.6 million (equal to 40 percent of the $4 million remaining after payment of the $1 million penalty). But Patel said that if the decedent’s estate were to instead make the disclosure and at least one of the individual’s heirs had known about the undisclosed account before the date of death, the IRS would demand an estate tax of $2 million (equal to 40 percent on the entire $5 million value of the estate before payment of the $1 million penalty). “The IRS is being punitive here,” Patel said. “Why should it make any difference whether the taxpayer dies before the disclosure is made or after?”

“**The IRS is hiding a secret policy meant to punish family members who knew about a foreign account but couldn’t do anything about it at the time,**” Patel said.

Patel noted that the IRS has issued no public guidance on the issue, forcing his firm to search for the relevant policies through a FOIA request. “The IRS is hiding a secret policy meant to punish family members who knew about a foreign account but couldn’t do anything about it at the time,” he said.

**Similarly Situated Taxpayers**

An IRS official confirmed to Tax Analysts that the agency has not published any guidance on the issue. However, it appears that McDougal explained the IRS’s thinking when he discussed Question 41 in the OVDP frequently asked questions for 2014 in his March 9, 2015, memo.

Question 41. If there are multiple individuals with signature authority over an OVDP asset held in the name of a trust, does everyone involved need to file delinquent [foreign bank account reports]? If so, must everyone pay the offshore penalty?

Answer: Only one offshore penalty will be applied with respect to voluntary disclosures relating to the same OVDP asset. The penalty may be allocated among the taxpayers with beneficial ownership making the voluntary disclosures in any way they choose. The reporting requirements for filing an FBAR, however, do not change. Therefore, every person who is required to file an FBAR must file one.

In his memo, McDougal said the IRS has: taken the position that the purpose of this FAQ was to avoid allocation controversies and provide a convenience to taxpayers, not to allow a family that happened to include a decedent to pay a lower effective penalty rate than a similarly situated family who were all living. In such cases, we have told the taxpayers that we will only allow allocation of the penalty among the living taxpayers. If they want to pay with estate assets, we have conditioned acceptance of those payment arrangements on the taxpayers agreeing that the payment is made on behalf of the heirs. That way it is clear that the payment is a distribution and not a payment of the decedent’s debt.

Patel said McDougal’s statement of the IRS’s position in the memo supports his client’s case because McDougal went on to say that “if the only disclosing taxpayer is the decedent, then the estate will be entitled to deduct the tax, interest, and penalty.”

Patel said the IRS should respect its internal position, as expressed in the McDougal memos, and allow the deduction for the penalty as an administrative expense because the estate made the disclosure and not the daughter. He added that if the IRS doesn’t back down, his secondary argument will be that the OVDP penalty reduces the value of the taxable estate at date of death.

“Since deductions are allowed by legislative grace, a court could say that these people have dirty hands, so we aren’t going to allow it,” Patel said. “But that’s a different issue than the estate’s value at the time of death, for which the body of law is even stronger in our favor. In that case, it becomes a simple mathematical calculation.”

Patel said the IRS told him it would issue his client a notice of deficiency a month ago. After three weeks passed, Patel said he sent a letter demanding the notice be issued but has yet to receive a response.
In an opinion filed March 29, the court found that the plaintiffs had asserted facts sufficient to support a reasonable belief that a letter sent by Gonzalez to Shire employees expressing his confidence in the potential of the combined organizations and remarking that the ensuing months would be very busy in light of integration planning was false or misleading, rather than immaterial “puffing” or “corporate optimism.” Gonzalez’s letter was sent one week after Treasury issued the anti-inversion guidance, Notice 2014-52, 2014-42 IRB 712.

But the court further found that the plaintiffs failed to “state with particularity facts giving rise to a strong inference” that Gonzalez acted with the scienter required to establish liability under section 10(b) of the Securities Exchange Act of 1934 when he sent the letter dated September 29, 2014.

“The complaint does not allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness,” the court said, adding that the closeness in time between Gonzalez’s letter and AbbVie’s announcement that the deal would be reconsidered is not strong enough evidence that Gonzalez knew when he sent the letter that AbbVie would reconsider or call off the deal.
“If AbbVie was concerned about hiding the importance of the tax consequences even after Treasury issued its Notice, then why would its announcements that it was reconsidering and calling off the deal make clear that the Notice was the reason?” the court asked in the opinion. The pleadings fail to demonstrate why Gonzalez would lie or act with reckless disregard for the truth by implying the transaction was advancing if he knew at the time that AbbVie’s board of directors would be reconsidering its approval, the court said.

The plaintiffs also failed to assert facts sufficient to support a reasonable belief that six additional statements or omissions by AbbVie raised in the complaint were misleading, according to the court.

Regarding the plaintiffs’ allegation that AbbVie’s June 2014 announcement that it had approached Shire about a business combination was misleading, the court, quoting *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995), said, ‘‘Mere silence about even material information is not fraudulent absent a duty to speak.’’

The plaintiffs claimed that a number of public statements AbbVie made between June and August 2014 about the strategic rationales for the proposed merger with Shire downplayed the importance of the deal’s tax benefits, listing tax considerations as only one of several rationales. The court said the plaintiffs did not assert facts sufficient to support a reasonable belief that those statements were misleading by omission ‘‘such that AbbVie had a duty to disclose that it might call off the merger if the tax rules changed.’’

The court found the facts insufficient to support a reasonable belief that a statement by Gonzalez during a July 2014 investor call regarding the importance of tax synergies to the deal was false. Gonzalez had said tax benefits were not the primary rationale for the merger and that AbbVie would not be doing the deal ‘‘if it was just for the tax impact.’’

AbbVie’s loss of any benefit amounting to approximately 3 percent of the deal value represented by the $1.64 billion breakup fee or more could be expected to cause AbbVie to terminate the deal, the court said. ‘‘But it does not follow that any benefit of the deal that is worth at least 3% of the transaction value must be the ‘primary’ — i.e. the ‘most important’ — reason for the deal,’’ the opinion states.

The court found that the relevant period for examining loss causation was from September 29, 2014, the date of Gonzalez’s letter, to October 14, 2014, when AbbVie announced its board was reconsidering the merger. That is a much shorter period than what was alleged by the plaintiffs, which stretched from the June 20, 2014, announcement of AbbVie’s approach to Shire until October 14, 2014. The plaintiffs’ loss causation allegations were therefore found insufficient as to several of the plaintiffs but sufficient as to plaintiffs William McWade and Vikas Shah, who bought or sold Shire shares between September 29 and October 14.

Since the termination of the merger, Shire has acquired New Jersey-based NPS Pharmaceuticals Inc. and announced its agreement to acquire Illinois-based Baxalta Inc., which was spun off from its U.S. parent company, Baxter International Inc., in July 2015. (Prior coverage: *Tax Notes*, Jan. 19, 2015, p. 319; and *Tax Notes*, Jan. 18, 2016, p. 308.)
Puerto Rico’s AMT Unconstitutional, U.S. Court Holds

By Alexander Lewis — alexander.lewis@taxanalysts.org

Federal Judge José Antonio Fusté of the U.S. District Court for the District of Puerto Rico held March 28 that a portion of Puerto Rico’s alternative minimum tax is unconstitutional and has granted Wal-Mart an immediate injunction against the secretary of the commonwealth’s treasury to stop collection of tax.

The 109-page decision in Wal-Mart Puerto Rico Inc. v. Juan C. Zaragoza-Gomez, 3:15-CV-03018 (JAF), says the tangible property tax portion of the AMT applies at a higher rate on transactions between a company in Puerto Rico and a foreign related party than it does on purely domestic transactions. Before a May 2015 amendment as part of Act 72 of 2015, Wal-Mart paid a 2 percent tangible property tax on applicable transactions. The rate under the amended provision is 6.5 percent.

In effect, every purchase of goods by Wal-Mart Puerto Rico from its parent company in the United States after the May 2015 amendment was subject to the higher tax rate. The court found that for the tax year that ended on January 15, Wal-Mart Puerto Rico paid more than $40 million in estimated income tax to Puerto Rico, around $30 million of which was attributable to the amended AMT.

By virtue of the 2 percent tangible property tax, the court found that Puerto Rico’s AMT clearly discriminates against interstate commerce, Fusté said, holding that the practical effect of the tax is to place an undue burden on multinational companies operating in Puerto Rico.

The court also held that the tax violates the Federal Relations Act and the equal protection clause of the Constitution. The Federal Relations Act provides that Puerto Rico can levy taxes on goods manufactured, sold, or brought into Puerto Rico, provided that Puerto Rico does not discriminate between goods produced in Puerto Rico and those produced in the United States or other foreign countries. The court found that the AMT violates the Federal Relations Act for the same reason it violates the dormant commerce clause — it clearly discriminates against products brought into Puerto Rico from the United States.

The AMT violates the equal protection clause “because it is both arbitrary in its discrimination and not rationally connected to a legitimate governmental purpose,” the court said. It found that the AMT was not intended to prevent abusive transfer pricing practices, as Puerto Rico argued, but was instead intended to quickly raise revenue for its treasury, which is not a legitimate purpose justifying a discriminatory tax.

Puerto Rico argued that the case should be dismissed because by law, Wal-Mart must first pay the tax and then seek a refund. However, both parties agreed that Puerto Rico would not be able to pay Wal-Mart the refund because the government is practically insolvent. “The AMT is a legislative money grab, pure and simple, funding the personal account of Puerto Rico’s insolvent treasury,” Fusté said.

The court found that the tangible property tax provisions of the AMT violate the legal doctrine known as the dormant commerce clause, which provides that states cannot place excessive burdens on interstate commerce without congressional approval. However, the tangible property tax in the AMT applies only if the seller or transferor is not subject to income tax on the transaction in Puerto Rico but the buyer is. In other words, the tax applies only to cross-border sales or transfers by an out-of-state company to its local branch or office.

Fusté cited Comptroller of the Treasury v. Wynne, 135 S. Ct. 1787 (2015), in writing that a state may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state. To determine whether a tax discriminates against interstate commerce, the court must look to the practical or real economic effect of the tax, he said.

“Puerto Rico’s AMT, on its face, clearly discriminates against interstate commerce,” Fusté said, holding that the practical effect of the tax is to place an undue burden on multinational companies operating in Puerto Rico.

However, Fusté said the AMT does not violate the constitutional prohibition against a bill of attainder law, as Wal-Mart claimed. The prohibition on bills of attainder in article 1, section 9 of the U.S. Constitution applies only to Congress, and the prohibition in article 1, section 10, applies only to the states. The court held that because Puerto Rico is a territory, the prohibition on bills of attainder does not apply. However, while the court agreed with Puerto Rico that the AMT does not violate the prohibition on bills of attainder, it still found the AMT unconstitutional.

Fusté lamented the condition of Puerto Rico’s finances, but the court agreed with an expert witness’s testimony that “at the end of the day, the Commonwealth should not rely on revenue that it’s not entitled to, to try to pay for essential services.”

‘The AMT is a legislative money grab, pure and simple, funding the personal account of Puerto Rico’s insolvent treasury,’ Fusté said.
Business Test Met, Common Control Found in *Sun Capital*

By Marie Sapirie — marie.sapirie@taxanalysts.org

Two private equity funds were engaged in a trade or business and under the common control of a bankrupt company, and thus were responsible for the withdrawal liability for a multiemployer pension fund, the U.S. District Court for the District of Massachusetts held in a case on remand from the First Circuit.

The March 28 district court opinion in *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 10-10921 (Mass. 2016), is a complete win for the pension fund, said Steven M. Rosenthal of the Urban-Brookings Tax Policy Center. The decision “further undercut[s] the assertions by private equity funds that they are merely passive investors and are not subject to the tax and ERISA rules that apply to a trade or business,” he said.

The First Circuit held in 2013 (No. 12-2312 (1st Cir. 2013)) that one of the Sun Capital funds was engaged in a trade or business under the multi-employer pension termination liability rules and asked the district court to examine the other. The circuit court also asked the district court whether either of the funds satisfied the common control test such that they would be liable for a termination penalty under the Multiemployer Pension Plan Amendments Act.

The private equity funds, which sit under Sun Capital Advisors Inc., filed a petition for certiorari with the Supreme Court that was denied. (Prior coverage: *Tax Notes*, Mar. 10, 2014, p. 1024.) The petition asserted that the First Circuit’s opinion “obliterated [the Supreme Court’s] clear line between an investor and a ‘trade or business’” and that the “novel, multi-factor ‘investment plus-like’ test” was unpredictable. (Prior coverage: *Tax Notes*, Nov. 25, 2013, p. 819.)

**District Court Decision on Remand**

The two main parts of the district court decision on remand addressed whether the funds were engaged in a trade or business and whether the two funds could be aggregated for purposes of determining if there was common control of the bankrupt company under the ERISA rules, which normally require 80 percent ownership of a company to establish control. The Sun Capital funds argued they did not control the company under the ERISA rules because one fund owned 70 percent of the company and the other owned 30 percent of the company, each under 80 percent.

The trade or business aspect of the decision highlights the possibility that fee offsets might represent some sort of phantom income to private equity funds for tax purposes, said Peter J. Elias of Jones Day.

The court explained that Sun Fund III received an economic benefit in the form of an offset against the management fees it otherwise would have paid its general partner for managing the investment in Scott Brass Inc. Elias said the trade or business part of the decision makes sense for the same reasons that were discussed in the First Circuit’s opinion, namely that the funds are investing and are receiving economic benefits in the form of fee offsets.

The district court answered in the affirmative the First Circuit’s question whether Sun Fund III received any benefit from an offset from fees paid by Scott Brass, a potential factor the First Circuit said might separate a passive investor from an active trade or business. “The generation of Management Fee offset carryforwards is a valuable benefit that accrues to the Sun Funds as a result of the Sun Funds’ management activities relating to Scott Brass, Inc.” that contributed to the trade or business finding, according to the district court.

The district court’s analysis of the question of common control concluded that despite the funds’ disclaimer in their agreements to co-invest without any intention to form a partnership, there was a “deemed partnership” between Sun Fund III and Sun Fund IV based on the record. The court looked to the common practice of using funds that invest in parallel as evidence in support of aggregation.

“That ownership interests sometimes can be aggregated across parallel funds illustrates why, as a general proposition, they sometimes can be aggregated across non-parallel funds,” the court wrote. The opinion further explains that all of the Sun Funds, whether parallel or not, were formally independent entities with separate owners but ultimately made their investment and business decisions under the direction of two leaders. The court also found that the funds decided on a 70-30 split in their ownership stake, which it said demonstrates the existence of a partnership because the split did not “stem from two independent funds choosing, each for its own reasons, to invest at a certain level.”

The court called the de facto separate entity a ‘partnership-in-fact,’ which is an important development under ERISA, Rosenthal said.

The court called the de facto separate entity a “partnership-in-fact,” which is an important development under ERISA, according to Rosenthal. Withdrawal liability will be much easier to trip, he
explained. Rosenthal also highlighted the district court’s finding that the deemed partnership engaged in a trade or business, even though it did not receive any fees or offsets. The district court held that the deemed partnership’s “active management in pursuit of profits from restructuring was not mere passive investment but something more.”

Elias said the conclusion that Sun Fund III and Sun Fund IV formed a de facto partnership was surprising. “Private equity funds set up parallel funds and invest in conjunction with each other all the time,” he said. “This suggests that any time that happens, it creates a fictional partnership for tax purposes.” He noted that the authorities relied on by the district court are general tax law authorities that apply for all purposes of the tax law, which makes it harder to assert that the district court’s analysis on the common control question applies only to the facts before the court.

Sentence Commuted for Drug Dealer Who Filed False Returns

By David van den Berg —
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President Obama commuted the sentences of 61 people on March 30, including Jesse Webster of Chicago, a man who had been sentenced to life in prison for intent to deal cocaine and for two counts of filing false tax returns.

A jury found Webster guilty of filing false tax returns based on evidence that he had failed to report income from drug dealing. Webster’s sentence is now scheduled to expire September 26, and the balance of a $25,000 fine imposed on him will be remitted, the White House said in its March 30 announcement of the sentence commutations.

Jessica Ring Amunson of Jenner & Block, who has represented Webster pro bono since 2009, said she informed Webster of the commutation March 30. He was “both excited and kind of a little bit stunned,” as well as grateful to her and to Obama, she said. “I assured him that although our legal fight is over, I certainly hope to continue to work with him to make sure his transition is a successful one,” she added.

Amunson started representing Webster when her firm was appointed as his pro bono counsel by the Seventh Circuit in his appeal of a habeas corpus petition regarding an unaccounted-for juror during deliberations, she said. It bothered her that Webster was serving a life sentence for a nonviolent drug crime and for filing false returns, and she found the punishment disproportionate with the crime, she said, adding that she then offered to continue representing Webster after he lost the appeal.

The judge who sentenced Webster said the term he was forced to impose was ‘too high,’ FAMM said.

Amunson submitted Webster’s petition to the Office of the Pardon Attorney in September 2013, and it included letters from the judge who sentenced him, the prosecutors who worked on his case, and many community and family members, she said. “When we first filed it, I thought it was really kind of a long shot because in past administrations, clemency, and commutations of sentence in particular, have been extremely rare,” Amunson said.

In a March 30 release, Families Against Mandatory Minimums (FAMM), an organization working for sentence reform, touted Webster’s commutation
as one of several it championed. According to the group, Webster was sentenced in 1996 for his role in a cocaine conspiracy, his first and only drug offense. The judge who sentenced Webster said the term he was forced to impose was “too high,” FAMM noted.

“We are deeply gratified that the President has used the power of the Oval Office to give relief to people serving unjust sentences, for low-level, non-violent crimes,” Julie Stewart, FAMM’s president, said in the organization’s statement. “Unfortunately, clemency can’t change policy.”

Webster’s case has attracted considerable attention. The city of Chicago in January 2014 unanimously passed a resolution calling for the commutation of Webster’s sentence, according to a February 2014 statement from Jenner & Block. The New York Times and other outlets have also reported on the case.

Webster’s commutation follows the December 2014 pardon of criminal defense attorney Albert Stork of Colorado, who died of terminal brain cancer less than a month after receiving a pardon for filing a false tax return. President Clinton issued at least 15 pardons related to individual or corporate income taxes, including the controversial pardon of Marc Rich in 2001, while President George W. Bush issued four pardons for income tax evasion and other tax-related offenses. (Prior coverage: Tax Notes, Jan. 12, 2015, p. 203.)

**Tax Court Refuses to Disregard Peek in IRA Loan Case**

*By Andrew Velarde — andrew.velarde@taxanalysts.org*

A decision from the Tax Court on March 29 should serve as further warning to taxpayers who would seek to invest IRA funds in their own business, a practitioner told Tax Analysts.

“There’s a fairly robust industry advising folks how to use their retirement funds to invest in their own businesses,” Alden Bianchi of Mintz, Levin, Cohn, Ferris, Glovsky, and Popeo PC said. “The prohibitive transaction rules are godawful complex. What Congress really wanted to do is for the IRAs to be retirement vehicles, not a way to buy yourself a job, or pump up your own investment, or use it for seed money for your highly leveraged start-up.”

> ‘What Congress really wanted to do is for the IRAs to be retirement vehicles, not a way to buy yourself a job, or pump up your own investment, or use it for seed money for your highly leveraged start-up,’ Bianchi said.

In *Thiessen v. Commissioner*, 146 T.C. No. 7 (2016), married petitioners acquired an incorporated business using funds from a retirement account on the advice of a broker. The petitioners rolled over their retirement funds into IRAs and caused the IRAs to acquire the stock of a newly formed C corporation (Elsara), which would acquire the unincorporated business (Ancona). The broker recommended that the acquisition of the existing business be structured to include a loan from the seller so that the seller would have an interest in helping the buyer in the future. Repayment on the loan was personally guaranteed by the petitioners. The petitioners retained a CPA for the transaction and an independent attorney with no ties to either the CPA or the broker to aid in the terms of the sale contract and financing arrangement.

The petitioners transferred the funds from their retirement accounts as tax-free rollovers in 2003 and reported them as such to the IRS without disclosing their guaranties of the loan. In 2010, on the theory that the distributions were prohibited transactions under section 4975 and therefore deemed distributions to petitioners, the IRS determined that the petitioners were liable for a deficiency attributable primarily to unreported IRA distributions totaling $431,500, as well as a 10 percent additional tax imposed under section 72(t) because of the prematurity of the distributions.

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The court’s decision to side with the IRS “didn’t surprise me in the least. . . . This is not breaking any new ground,” Bianchi said.

Under section 4975(c)(1)(B), a prohibited transaction generally includes the direct and indirect lending of money or other extension of credit between a plan and a disqualified person. A disqualified person includes one who exercises discretionary authority or control over management of the plan or disposition of its assets.

The court agreed with the IRS on its primary argument, citing its previous opinion in Peek v. Commissioner, 140 T.C. 216 (2013), and refusing petitioners’ request to disregard or distinguish that opinion. One argument advanced by the petitioners was that the Department of Labor had the primary authority to interpret prohibited transaction rules and that the court in Peek interpreted them inconsistently with the department.

In Peek, an IRA funding structure had been promoted to two unrelated taxpayers, who rolled over funds in their retirement plans to self-directed IRAs and caused the IRAs to establish a newly formed corporation, which purchased assets of a business by receiving from the seller a loan that the taxpayers guaranteed. The court in Peek held that the taxpayers were disqualified persons and that the guarantees of the loan were prohibited transactions. The petitioners in Thiessen asserted that Peek was distinguishable because Elsara, unlike the corporation in Peek, was an operating company, which the court rejected.

“We decline petitioners’ invitation to disregard or distinguish Peek. Congress included provisions on prohibited transactions in both title 26 and title 29, and President Carter gave the Department of Labor primary authority to interpret both sets of those provisions,” the court held. “That does not mean, however, that the Department of Labor has the final word as to the interpretation of those provisions.” As a secondary matter, the court found that the department concluded in a similar setting to Peek that a personal guaranty would be a prohibited transaction. Further, in Peek, an operating company was never mentioned, the court noted.

Richard Matta of Groom Law Group Chtd. agreed with the court’s holding, though not all of its technical analysis.

“People are sort of testing every theory they can come up with to find a way to do these deals,” Matta said. “[They] invest in their own businesses, pay their salaries, get these guaranties in place . . . though I think the Tax Court could have found a simpler way to get from point A to point B.”

Although the court cited the Department of Labor’s plan asset regulations, Interpretive Bulletin 75-2 stands for the proposition that an indirect transaction could not be used to accomplish a transaction that could not be done directly, Matta argued. Interpretive Bulletin 75-2 was not cited in the opinion. Further, although the court ignored the petitioners’ argument that would distinguish an operating company because the IRAs are related, the rules apply to relation in a common employer, Matta noted.

Although section 4975(d)(23), added to the code as part of the Pension Protection Act of 2006, generally provides that prohibitions in section 4975(c)(1)(B) do not apply to the lending of money between a plan and a disqualified person in connection with the acquisition, holding, or disposition of any security or commodity, if the transaction was corrected before the end of the correction period, the petitioners’ acquisitions of assets failed to meet the definition of security or commodity, the court held.

“While petitioners gave the guaranties incident to an overall plan that included petitioners’ IRAs’ acquisition or holding of Elsara stock, the aim of the transaction, to be sure, was to acquire Ancona’s assets rather than to acquire Elsara’s stock,” the court held, finding that the “more appropriate characterization” of the guaranties was that they were given in connection with an asset acquisition. Although the three-year limitations period for assessment expired, the IRS sought to rely on the six-year period, which required a showing that the petitioners failed to report gross income in excess of 25 percent of the amount reported on the 2003 return. Despite their contention, the amounts in question were not disclosed in the return, the court held in allowing the six-year assessment period.

“Petitioners’ primary argument is flawed in that it rests on the proposition that petitioners’ disclosure of the rollovers as tax-free is sufficient to put respondent on notice that petitioners engaged in the prohibited transactions,” the court held. “The 2003 joint return therefore offers not even a clue as to the existence, nature, or amount of any omitted income. We conclude that a reasonable person would not discern from the 2003 joint return that petitioners omitted any gross income for 2003.”
Tax Court Issues Proposed and Interim Rules for Tax Law Changes

By Nathan J. Richman — nathan.richman@taxanalysts.org

The Tax Court released March 28 a batch of proposed and interim rule changes to account for changes in three pieces of tax legislation from the end of 2015, including interest abatement, partnership audits, and passports.

The rules relate to amendments made by the Bipartisan Budget Act (BBA) of 2015 (P.L. 114-74), the Fixing America’s Surface Transportation Act (FAST Act) (P.L. 114-94), and the tax extenders bill (P.L. 114-113). The Tax Court asked for comments by April 30. This is the second set of rule changes related to the extenders bill that the Tax Court has released this year. (Prior coverage: Tax Notes, Mar. 7, 2016, p. 1117.)

The BBA changes are proposed rules adding a title governing the new default partnership audit regime, which will replace the 1982 Tax Equity and Fiscal Responsibility Act and allow the IRS to assess and collect tax due on partnership adjustments at the entity level. The proposed rules set out the procedure for petitioning the Tax Court on a notice of final partnership adjustment under section 6231(a)(3), as well as those for joinder, pleadings, and the effect of the Tax Court’s decision on the partnership and its partners. The Tax Court proposed those rule amendments because, while partnerships may elect to apply the new rules early for tax years starting between November 3, 2015, and December 31, 2017, “it is unlikely that a petition to which those amendments would apply will be filed in the near future,” according to the explanation in the release. (Prior coverage: Tax Notes, Mar. 21, 2016, p. 1398.)

Miriam L. Fisher of Latham & Watkins LLP said that the new regime, replacing the tax matters partner with a partnership representative and assessment of tax liabilities at the partnership level, required a new process for the partnership representative to file a petition in response to a final partnership adjustment. The proposed rules contain standard procedures accounting for the new regime, she said. “You have a new person who is the only person authorized to file [the petition], it’s a partnership-level proceeding that only the partnership is participating in, so while it’s a little different [from TEFRA], the basic procedural mechanics for filing a petition are the same,” she said. (Prior coverage: Tax Notes, Nov. 2, 2015, p. 644.)

The FAST Act changes similarly create a new title to govern challenges to IRS certification decisions. Under section 7345, the IRS submits a certification that a taxpayer has a “seriously delinquent tax debt” to Treasury, which passes that certification on to the State Department. It is the State Department that chooses whether to deny, revoke, or limit a taxpayer’s passport at that point — the only IRS decision, and thus the only decision subject to a petition in the Tax Court, is the certification, or failure to reverse a certification, that the taxpayer has a “seriously delinquent tax debt.” (Prior coverage: Tax Notes, Dec. 14, 2015, p. 1365.)

The certification rules and the partnership audit rules are proposed, rather than interim, because the Tax Court does not expect those petitions any time soon.

Like the partnership audit changes, the proposed certification rules create new procedures for petitioning the Tax Court over an IRS certification or failure to reverse a certification. The certification rules are proposed, rather than interim, for the same reason as the partnership rules: The Tax Court does not expect those petitions any time soon.

Fisher said that the proposed certification petition rules are necessary because the addition of section 7345 “creates new jurisdiction for the Tax Court to hear an action which never existed before.” She said that the proposed rules adopt normal procedures for the new type of petition.

Michael J. Desmond of the Law Offices of Michael J. Desmond said, “While the proposed rules governing those proceedings look relatively straightforward, when Congress has in the past expanded the court’s jurisdiction into a . . . new area, a significant amount of litigation has followed as taxpayers, the IRS, and the courts wrestle with issues that Congress may not have fully considered.”

Interim Rules

In contrast to the BBA and FAST Act changes, the Tax Court amended its rules in accordance with the tax extenders bill on an interim basis because it “has determined that there is an immediate need to adopt the interim amendments,” although the same provisions are also proposed rules to allow for public comment. The interim rule changes related to the tax extenders include adoption of the Federal Rules of Evidence in section 7453, the inclusion of innocent spouse relief and levy collection due process appeals under sections 6015 and 6330 in the bankruptcy suspension of the period to file a petition, and the ability to petition a request to abate
interest after 180 days have elapsed in addition to an explicit denial. (Prior coverage: Tax Notes, Jan. 4, 2016, p. 60.)

The replacement of the rules of evidence used in the U.S. District Court for the District of Columbia with the general Federal Rules of Evidence has the effect of applying the *Golsen* rule (named for *Golsen v. Commissioner*, 54 T.C. 742 (1970), aff’d, 445 F.2d 985 (10th Cir. 1971)) to evidence issues as well as substantive law issues. Under the *Golsen* rule, the Tax Court applies the case law of the circuit to which the petitioner’s case is appealable. Because it applies to cases already pending in the Tax Court after December 18, 2015, “to the extent that it is just and practicable,” Desmond said that the change in the rules of evidence could have an immediate effect. “It will be interesting to see if any cases trigger the transition rule, particularly on issues like work product protection where there may be a split in circuit court authority,” he said, referring to the circuit split between *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009), cert. denied, 130 S.Ct. 3320 (2010), and *United States v. Deloitte LLP*, 610 F.3d 129 (D.C. Cir. 2010).

The interim, and proposed, interest abatement petition rules split the previous rules for petitions from an affirmative denial by the IRS to address both denial and lapse of 180 days. Fisher said that the two roads to the Tax Court jurisdiction (denial or time lapse) now mimic the two roads for non-Tax Court jurisdiction over refund claims.

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**Pro Bono Clinic Days Offer New Option to Help Pro Se Petitioners**

By Nathan J. Richman  
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Taxpayers seeking help navigating the Tax Court normally have two options: low-income taxpayer clinics (LITCs) or calendar call volunteer programs generally on the day of the trial session. Taxpayers with incomes that don’t meet the qualifications for the LITCs generally have few options for pro bono help before they set foot in court.

A Maryland pro bono clinic day could change that. The pro bono day provides free tax advice and the chance to talk with an IRS representative two to three months before the Tax Court’s calendar call, according to Cheri P. Wendt-Taczak of Kelly Dorsey PC. The program, which now rotates between the downtown Baltimore LITC offices of the University of Maryland and the University of Baltimore, was first launched in July 2013 by the Maryland Volunteer Lawyers Service (MVLS), the University of Maryland LITC, and the Maryland State Bar Association (MSBA) Tax Section Pro Bono Committee, she said.

The program emerged from a March 2013 MSBA Tax Section study group meeting. Wendt-Taczak, then the program attorney for the LITC at MVLS, and Nancy M. Gilmore, associate area counsel (Baltimore), IRS Small Business/Self-Employed Division, were discussing calendar calls and pro se petitioners. Wendt-Taczak raised the possibility of “providing something similar to the calendar call program that the court does but [offering] something like that to petitioners ahead of time,” Gilmore said.

The pro bono day’s sponsors jointly draft a letter for the IRS to send out to pro se petitioners, usually four or five weeks before the pro bono day, Wendt-Taczak said. The letter, accompanied by an IRS cover letter, describes the opportunity for free tax advice, including the chance to speak with an IRS representative, related to the petitioners’ Tax Court cases. The letter directs interested petitioners to contact the MVLS to schedule appointments, she said. The letter states that the volunteers will provide advice at the pro bono day but will not enter an attorney-client relationship on that day.

The IRS sends the letter because it cannot provide the petitioners’ addresses to the clinics and volunteer programs under section 6103 disclosure rules, Gilmore said. The letter is distinct from the stuffer notices the court sends out notifying petitioners of LITCs and volunteer programs, Wendt-Taczak noted.
Beverly Winstead of the LITC at the University of Maryland Francis King Carey School of Law said that pro se petitioners can come to the pro bono days with the notices they have received from the IRS and their records. If a petitioner falls within a clinic’s income guidelines, the clinic may take the case, beginning an attorney-client relationship, and enter an appearance before the Tax Court, she said. “But the thing that makes the [pro bono] days really, really great, I think, and beneficial for the LITC is... it gives the student attorneys the opportunity to really do thorough research, because we have more resources to research issues at the pro bono day than at calendar call, and we are not under pressure like when we are at calendar call,” she said.

Wendt-Taczak said that the appointments typically last 30 to 45 minutes and provide a better environment for tax advice, with four conference rooms with large tables to spread out documents, compared with courthouse halls at calendar call. The pro bono day typically runs from 2 to 7 p.m., she said. Appointments have run as long as two hours, Winstead said.

Gilmore said that she has been the IRS representative at most of the pro bono days so far. She said she takes all of the legal files, and as many of the administrative files as she can, for the cases scheduled, and that she has a separate office space where she stays until one of the petitioner conferences asks for IRS input. When that happens, someone takes her to the appropriate conference room where she can provide information such as the IRS view of the case, what issues have been raised (often needed if the petitioner has not retained the notice of deficiency or determination letter), and what information the IRS will need to settle the case, she said. “It allows me to explain in shorthand to the other attorney what’s going on so that that attorney can then interpret it to the taxpayer,” Gilmore said.

While typically more than half of the petitioners at pro bono day ask for IRS input and often have documents to show her, Gilmore said that most of the time she does not reach a settlement that day. “I will take the documents and tell them what to expect and when to expect it [or] what else they need to provide in addition to what they are giving us now,” she said.

Gilmore said that her day at the clinic is similar to her experience dealing with petitioners on the day of calendar call, “except we have more time to sit down and explain things to the taxpayers. They have more time to understand it, to grasp what’s going on.”

Program Results
The Maryland clinic sponsors said that attendance has been consistent and substantial, if not overwhelming. The benefits to taxpayers have been noticeable, too, they said.

Wendt-Taczak estimated that one-quarter of the petitioners who received the letter scheduled appointments and only one or two typically cancel. Over 70 percent of the cases of petitioners who attended a pro bono day are settled before calendar call, she said. While the average pro bono day has eight or nine appointments, there have been as many as 20 and as few as five, Wendt-Taczak said.

Gilmore estimated there is a 25 percent response rate with “very few cancellations” and that approximately 80 percent of attendees settle before calendar call. While the settlement rate is close to the overall settlement rate for Tax Court cases, the pro bono days have led to far fewer continuances, she said, adding that almost half of pro se petitioner cases without the pro bono day meeting get continued (pushed to a later trial session) when the taxpayer first shows up at calendar call but that almost none of those where the petitioner has been to pro bono day do.

Some cases get settled at calendar call, Gilmore said, “but it is generally not as favorable to the taxpayer because we are not able to get as much information to support their position.” The more time the IRS has to get information from the taxpayer, the more likely it will arrive at the correct result, she said.

One of the biggest problems for the IRS and one of the impediments to pro bono day attendance is that petitioners often do not respond to mail from the IRS attorneys, according to Gilmore. The problem for pro bono days is that the IRS has to send out the invitations because of taxpayer privacy concerns.

Not only are pro se petitioners often unprepared to try a case, but often the first time they provide documents to the IRS is at the calendar call or on the day of trial, Gilmore said. “It creates a very chaotic scene and usually ends up actually harming the taxpayer,” she said. Pro bono days can allow her to open up communication between the IRS attorneys and the pro se petitioners, she said. “The attorney now has a contact point, and somebody has actually spoken with the petitioner to tell them, ‘This is what’s going on, this is the attorney that is assigned to the case, you should expect to hear from them, and this is what you need to get to them,’” she said.
Gilmore singled out collection due process hearings as one area where the pro bono day can help a pro se petitioner. “A lot of times petitioners don’t understand what a CDP case really entails. . . . They think that the court can give them the collection alternative that they want; they don’t understand that that is not going to happen here,” she said. Instead, at pro bono day, the volunteer attorneys explain to pro se petitioners that they would be better off dismissing their cases and filing new offers in compromise or installment agreements, she said.

Eric M. Bielitz, the attorney who organizes the MSBA calendar call volunteer program, praised the response from the practitioner community. Even though the program is still fairly new and there are a few kinks to work out with regard to staffing levels, “our issue is not not having enough hands but having too many hands, which is a wonderful problem to have,” he said. “It is not uncommon to generally have one or possibly two attorneys and a couple of law students helping out some of these pro se folks at [pro bono day].”

Bielitz pointed to two additional benefits for petitioners beyond helping petitioners to understand the merits of their cases and to organize their arguments and documents. First, the volunteers can explain the basics of the rules of evidence and procedure, he said. Second, the volunteers can help ease the petitioners’ suspicions of IRS counsel, he said, adding that petitioners can be afraid to turn over information the IRS needs in discovery.

Winstead said that even for cases that still go to trial, the pro se petitioners can get a lot out of pro bono day. Particularly in a substantiation case, the volunteers can tell the petitioners, “Bring these documents; this is what a judge is going to ask you; this is the stuff you need to get on the record,” she said. Pro bono day is a chance for petitioners to meet with pro bono counsel in a much less stressful environment than the courthouse at the calendar call, she said.

**Ciraolo said the pro bono day program ‘was a success from day one.’**

Caroline Ciraolo, acting assistant attorney general in the Justice Department Tax Division, was part of the initial conversation between Gilmore and Wendt-Taczak while she was at Rosenberg Martin Greenberg LLP. “This would not be a success without the Baltimore [IRS] office,” Ciraolo said, attributing the success of the program to the work of Wendt-Taczak and Gilmore as well as Winstead, who was also involved in organizing the pro bono day program.

Ciraolo said the pro bono day program “was a success from day one.” The first pro bono day included six pro se petitioners, and several of those cases were resolved before trial, she said. “It has only been fine-tuned from there,” Ciraolo said.

Gilmore said that one of the reasons the program has been successful could be the geography of Maryland. “We are very fortunate in Baltimore that everything is very close together, so we are able to make this a single-day event and actually have somebody on site,” she said.

Gilmore said she thought that the act of petitioners making appointments could have led to the successful turnout for the program. “I think having people call in to make an appointment makes it more likely that they will actually appear. . . . They get it on their calendar and say, ‘Oh, I have to be there at this time,’” she said.

“One of the reasons for the success of this program is because so many of the Maryland law firms supported their attorneys’ participation,” Ciraolo said.

**Expansion and Reactions**

Pro bono day in Baltimore has been well received by the IRS, practitioners, and even the Tax Court, and similar programs are being tried all over the country.

Gilmore said that other cities have been trying programs similar to Baltimore’s pro bono day program. “Different people throughout the last couple of years have contacted me to ask for our experience,” she said.

Thomas Travers, assistant division counsel (tax litigation), SB/SE, said, “We have had pro bono days (or nights) in other cities, including Los Angeles and Seattle.” He said that these other attempts often involve variations, such as video conferencing.

Travers said that one of the main obstacles has been the reluctance of pro se petitioners to meet with the IRS or prepare for trial before the actual calendar call. The programs have been successful to the extent that those who have participated have been satisfied with the results in general, he said, “but trying to increase the participation is the challenge.”

Tax Court Chief Special Trial Judge Peter J. Panuthos has encouraged the bar to find more ways to help pro se litigants. “The Tax Court is very supportive of measures that help pro se petitioners resolve their tax issues more effectively and efficiently,” he told Tax Analysts. (Prior coverage: *Tax Notes*, May 19, 2014, p. 800.)

For more *Tax Notes* content, please visit [www.taxnotes.com](http://www.taxnotes.com).
Guinevere Moore of Johnson Moore LLC said volunteers have tried to hold pro bono days in Chicago, but “unfortunately, the petitioners just don’t come.” When it does work, though, she said, it could both help achieve a fairer settlement and help petitioners arrive at trial better prepared to present their cases.

Moore highlighted a separate important benefit if the pro bono day is at least 30 days before the calendar call: the opportunity to present a section 7430(g) qualified offer. A qualified offer must be made more than 30 days before trial and allows an award of fees, even for pro bono services, treating the taxpayer as the prevailing party as long as the total outcome is less than what the taxpayer offered the government to settle. A qualified offer is generally not an option for pro bono representation (as opposed to LITC representation) because the petitioner and pro bono counsel often first meet at calendar call, which can be the day of trial. (Prior coverage: Tax Notes, Mar. 7, 2016, p. 1118.)

“I find qualified offers to be a helpful settlement tool, and I think that creating a way to use that tool even if the attorney and the petitioner meet for the first time at the call would be a worthy use of time and effort,” Moore said. The 30-day qualified offer period does not reflect the realities of calendar call, she said.

Andrew R. Roberson of McDermott Will & Emery said, “I think a lot of clinics around the country are trying to do this with pro se taxpayers to see if they can resolve issues before the calendar call.” He said that many times, early resolution depends on educating petitioners on tax procedures and the documentation they need to give to the IRS. Some petitioners think the calendar call is when they are supposed to first meet with the IRS, not realizing that trial might be that week or even that day, he said.

Roberson said, “The Tax Court does a great job of putting the information out there in basic terms for pro se taxpayers, but the legal process, whether in Tax Court or elsewhere, can be very confusing to people, and a layperson might not understand how the process works.”

In a written statement to Tax Analysts, the American Bar Association Section of Taxation and its Pro Bono and Tax Clinics Committee said, “We applaud the efforts of these volunteers and IRS counsel to reach settlements in appropriate cases without the need for trial or involvement by the Tax Court . . . and the ability to meet with pro se taxpayers prior to the calendar call is an important step in ensuring that all taxpayers pay only the amount of tax that is legally due.”

Jennifer E. Breen and Sheri A. Dillon of Morgan, Lewis & Bockius LLP are two of the new directors of the Washington DC Center for Public Interest Tax Law, the organization that helps match pro bono attorneys with pro se petitioners. They said that they would be interested in a pro bono day program if IRS area counsel is interested. “We’d like to see what the best practices are and try to do something similar,” Dillon said. (Prior coverage: Tax Notes, Mar. 7, 2016, p. 1123.)

Breen said that she could see the benefit of meeting with pro se petitioners before the Tax Court trial session. “I think that it would be a better use of resources, especially the Tax Court’s, if they are able to get some sort of resolution earlier,” she said.

Dillon said that the program could alleviate an inefficient use of court, IRS, and taxpayer resources caused by the delay of a continued case. They would want to know “why it worked well in one large city but not in others,” she said.

Dillon said that the program could alleviate an inefficient use of court, IRS, and taxpayer resources caused by the delay of a continued case.

T. Keith Fogg, director of the federal tax clinic at Harvard Law School, said that he had been part of an effort to launch a pro bono day program in Philadelphia while at Villanova University but that petitioners did not participate that day. He said having the IRS send a letter notifying petitioners about the clinic and using relatively inaccessible IRS offices in downtown Philadelphia could have hampered the effort. “You have to find a place to hold it that’s convenient to the people who might be coming,” he said.

Fogg said that resolving the case more than 15 days before trial would save the IRS attorneys from having to prepare pretrial memoranda and motions to dismiss for lack of prosecution. He said that judges also benefit from having fewer cases in a trial session and would be able to better manage travel away from Washington.

In addition to those in Seattle and Los Angeles, Fogg said that he has heard of a successful program in Miami that uses multiple sites and video conferencing.

The pro bono day clinic is “another tool, and it sounds like a promising tool if we get the right places and the right time so that it’s convenient for taxpayers,” Fogg said.
NEWS AND ANALYSIS

Group Portrays Case as Last Hope Against Dark Money

By Paul C. Barton — paul.barton@taxanalysts.org

Public Citizen says in a new fundraising appeal that its pending lawsuit against the Federal Election Commission represents a legal last stand against the proliferation of undisclosed political spending through politically oriented nonprofits and other groups.

The advocacy group says oral arguments in the more than two-year-old case could come as early as May in the U.S. District Court for the District of Columbia. The case involves the FEC’s handling of the classification of Crossroads GPS, a group recently granted official section 501(c)(4) social welfare status by the IRS. (Prior coverage: Tax Notes, Feb. 15, 2016, p. 759.)

“If we win in court, it will take a serious bite out of Citizens United and all the Dark Money groups corrupting our democracy,” Robert Weissman, president of Public Citizen, said in the March 28 fundraising email. But he added, “If we lose this lawsuit, the Dark Money groups will have a green light to continue abusing Citizens United to lock in ever more power for their plutocratic puppet masters.”

‘If we win in court, it will take a serious bite out of Citizens United and all the Dark Money groups corrupting our democracy,’ Weissman said.

The reference is to the 2010 Supreme Court decision in Citizens United vs. FEC, 558 U.S. 310 (2010), which held that corporations could spend unlimited amounts on politics as long as they were not donating to particular candidates. The case is credited with spurring political activity through section 501(c)(4) groups, which are not required to publicly disclose donors. Such spending is widely referred to as dark money.

In its lawsuit, Public Citizen accuses the FEC of dereliction of duty in not declaring that Crossroads GPS had acted in 2010 more like a section 527 political committee, requiring disclosure of donors under campaign finance laws. The FEC instead deadlocked on the matter in December 2013 and dismissed the case. Public Citizen, leading a group of campaign finance reform advocates, then filed suit. (Prior coverage: Tax Notes, Dec. 1, 2014, p. 989.)

Crossroads GPS won the right to intervene in the case in June 2015. It is now regarded as an intervenor-defendant. (Prior coverage: Tax Notes, June 15, 2015, p. 1269.)

Election Code Issue

Craig Holman of Public Citizen told Tax Analysts that the IRS decision on Crossroads would have no bearing on the lawsuit. “The [501(c)(4)] issue is a tax code issue overseen by the IRS,” he said. “Public Citizen’s lawsuit is an election code issue overseen by the FEC. The case is whether Crossroads GPS should declare that it has as its major purpose the conduct of federal election activity and that the FEC itself is negligent in its duties by not making a decision on this question in compliance with established law and its own rules.”

But in February, Holman said of the IRS decision: “What I’m counting on is that a number of Crossroads and IRS records used in the application [for section 501(c)(4) status] are about to be made public. We may find some useful information for the lawsuit.” (Prior coverage: Tax Notes, Feb. 29, 2016, p. 984.)

Tara Malloy of the Campaign Legal Center, which is providing legal help to the Public Citizen group, said “it would have been nice” if the IRS had denied social welfare status to Crossroads, adding that that shouldn’t affect findings under election law. “These are really two very different bodies of law,” Malloy said.

David Keating, president of the Center for Competitive Politics, said he sees little chance of Public Citizen succeeding. “At most the court is going to send it back to the FEC and say, ‘Do it over,’” he said in an interview. “I think the courts are generally going to defer to the FEC’s judgment on this.”

The lead attorney for Crossroads in the case, Thomas W. Kirby of Wiley Rein LLP, did not respond to a request for comment.

But in a recently filed motion seeking dismissal of the lawsuit, Crossroads argues that Public Citizen bases its case on a method of calculating political activity never mentioned by the Federal Election Campaign Act (FECA) of 1971. Public Citizen contends that Crossroads’ Form 990, “Return of Organization Exempt From Income Tax,” for 2010 and other information make clear that it spent well over half of its funds that year on politics. But Crossroads, which was started by GOP political operatives Karl Rove and Ed Gillespie in June 2010, argues that FECA says nothing about measuring political activity by a “single-calendar-year metric.”

It adds: “Using any other available measuring period, such as Crossroads GPS’s disbursements collectively during 2010 and 2011 or during its first fiscal year, the opposite balance is seen. Because neither FECA nor court precedent commands a
narrow, rigid calendar-year approach to considering an organization’s major purpose, the controlling FEC Commissioners reasonably refused to engineer their analysis in that artificial way.”

In its fundraising appeal, Public Citizen says that in less than six years, Crossroads spent $142 million on politics. “Folks, this is a defining moment,” said Weissman. “We are taking on both the federal government and one of the all-time worst exploiters of Citizens United.”

Trump Attorneys Describe IRS ‘Examinations’

By Paul C. Barton — paul.barton@taxanalysts.org

Republican presidential front-runner Donald Trump on March 30 released a letter from his attorneys that purports to explain what he has portrayed as nonstop IRS audits of his tax returns.

Trump has pointed to ongoing audits over the past 12 years as preventing him from releasing copies of his tax returns, even though several other presidential candidates, including his two remaining rivals for the GOP nomination, Sen. Ted Cruz of Texas and Ohio Gov. John Kasich, have released theirs.

But many tax law practitioners and academics — as well as the IRS itself — have said that being under audit does not bar someone from releasing a return. (Prior coverage: Tax Notes, Mar. 7, 2016, p. 1083.)

However, the March 7 letter, from Sheri A. Dillon and William F. Nelson of Morgan, Lewis & Bockius LLP, does not use the word “audit.”

Instead, it describes Trump’s business empire as spanning roughly 500 entities collectively called the Trump Organization. “These entities engage in hundreds of transactions, deals, and new enterprises every year,” they wrote. “Because you operate these businesses almost exclusively through sole proprietorships and/or closely held partnerships, your personal federal tax returns are inordinately large and complex for an individual.”

As a result, they said, his returns have been under “continuous examination” since 2002, “consistent with the IRS’s practice for large and complex businesses.” The examinations for 2002-2008 have been closed “without assessment or payment, on a net basis, of any deficiency.”

The letter then says examinations of returns for years 2009 forward are ongoing and involve “continuing transactions or activities” that were also reported on Trump’s returns for 2008 and earlier. “In this sense, the pending examinations are continuations of prior, closed examinations,” the letter says.
“This is incomprehensible,” Neil H. Buchanan, professor of tax law at George Washington University, told Tax Analysts. “As far as I can tell, they are trying to say that he was not caught doing anything bad before 2009, because those investigations are closed, but that none of the returns can be released, because the older transactions are somehow relevant to the current audits. . . . This is, as far as I can tell, deliberately vague.”

Jay Soled, tax law professor at Rutgers University, said many large businesses have to maintain “a built-in office for the IRS” because “whatever they have going on requires constant oversight.” Soled said he suspects the IRS’s overarching concern about Trump’s returns involves whether they are reporting all his income. There is a six-year statute of limitations on substantial understatement of income, defined in section 6501(e) as 25 percent or more, and that may explain the 12-year span, he said, as well as why still-pending examinations could refer to what was reported on earlier returns.

Soled has also speculated that the IRS might be concerned about any captive insurance arrangements Trump might have. The IRS has long been wary of them because of their potential to serve as a tax dodge. (Prior coverage: Tax Notes, Mar. 21, 2016, p. 1381.)

Anthony J. Nitti, CPA at WithumSmith + Brown, said the letter “seems to choose its language carefully. It refers to ‘continuous examination,’ which means that Trump’s return is likely reviewed each and every year by the IRS, which does not happen to all taxpayers.” But Nitti added that that does not mean Trump is under continuous audit. “I think they use the word ‘examination’ rather than audit by design, because most people who read that will think they are one and the same,” he said.

Bottom line, “to me this is a well-crafted excuse for not releasing any returns,” Nitti said.

Calculator Estimates Candidates’ Tax Hits

By William Hoffman — william.hoffman@taxanalysts.org

With a few simple numbers and a click of your mouse, you can get a glimpse of how much, on average, your federal tax liability would be under four presidential candidates’ tax plans.

The Urban-Brookings Tax Policy Center (TPC) and the online news site Vox teamed up to provide a simple calculator for individual taxpayers curious whether real estate developer and Republican front-runner Donald Trump’s plans to slash income tax rates and social safety net programs would net you a better tax bill than the proposal by Democratic candidate Sen. Bernie Sanders, I-Vt., to raise taxes on almost everyone — especially the rich — while expanding government programs.

The online calculator, posted March 25 and inspired by a request from Vox and fortified with the TPC’s data and expertise, asks only for the taxpayer’s 2015 adjusted gross income, whether the taxpayer is single or married, and how many children (none, one, or two-plus) are in the household.

‘This is more of an average across a range of incomes and family categories,’ Williams said.

“It’s not really a tax calculator where you put in a certain set of numbers and out comes your tax,” said Roberton Williams, senior fellow at the TPC. “This is more of an average across a range of incomes and family categories.”

The TPC posted its own presidential candidates’ tax calculators in 2008 and 2012, after the parties made their nominations, Williams said. This is the first time the center has posted so early, he said, noting that the group still plans to release its post-convention calculator sometime later this year.

The calculations for the TPC-Vox calculator were made by analyzing the five remaining major candidates’ tax plans, Williams said. Ohio Republican Gov. John Kasich’s plan was too vague, so he has been left out, but plans from Trump, Sanders, Democratic former Secretary of State Hillary Clinton, and Texas Republican Sen. Ted Cruz provided enough to start, he added.

The TPC sent questionnaires to the latter four candidates in an effort to increase the plans’ specificity, Williams said. Clinton and Sanders replied;
Trump and Cruz did not, he said. “We had enough detail to evaluate the plans with some precision,” he added.

The Vox-TPC calculator leaves out a whole range of deductions, exemptions, itemizations, and other staples of tax return practice and preparation, Williams noted. It includes individual income taxes, payroll taxes, excise taxes, and corporate income taxes. The TPC plans to post to its website the tables that support the Vox-TPC calculator, which will allow visitors to see clearly what the calculator can and cannot do, he said.

The Tax Foundation is also launching a tax calculator soon, which will be posted on the USA Today website, said Kyle Pomerleau, the foundation’s director of federal projects. The Tax Foundation’s calculator will best serve individual wage earners, allowing them to estimate not only their tax liability under various candidates’ plans, but also their eligibility for some credits, such as the earned income tax credit, Pomerleau said.

Calculations for investment, real estate, and other types of income won’t be supported, Pomerleau said. “But for the majority who rely on wage income, not a plethora of itemized deductions, it will show how your tax bill will change,” he said.

Hudson Institute Tax Plan Strives For Fiscal and Political Balance

By William Hoffman — william.hoffman@taxanalysts.org

Tax economists and public policy researchers agreed March 30 that a new Hudson Institute tax plan offers a more fiscally responsible and politically realistic roadmap for tax reform than many of the current crop of Republican and Democratic presidential candidates’ proposals.

Each candidate’s tax plan tries to balance a bewildering variety of competing political, economic, and fiscal interests, said Kyle Pomerleau of the Tax Foundation during a panel discussion at the Hudson Institute in Washington.

“Generally on the Republican side, the focus in tax policy has been on fundamental tax reform,” including reducing marginal income and corporate tax rates, said Pomerleau. “The Democrats have been less interested in fundamental reform and more interested in new programs,” with higher taxes either on everyone or mostly on upper-income earners, he said.

The Hudson Institute’s Main Street Tax Plan “attempts to balance all these things — get some programs [started] in there, with some features that a lot of reformers want, but make sure that it pays attention to the politics and the arithmetic of fiscal policy,” Pomerleau said.

The Hudson plan’s author, Jeffrey H. Anderson, said most presidential candidates’ tax plans would benefit the top 1 percent of income earners more than typical Americans and that most would balloon the federal debt. The Hudson plan will spur economic growth, “clearly benefit the typical American,” and improve the nation’s fiscal situation by allowing the economy to grow its way out of debt, he said.

The Hudson plan would eliminate the Medicare payroll tax for employers and employees and fund Medicare from general revenues, make the top individual income tax rate 33 percent, create a new 20 percent individual rate to prevent the shock of low-income earners moving directly from the current 15 percent bracket to the 25 percent bracket, and cut the child tax credit by half while increasing the child care tax credit.
For businesses, the Hudson plan would reduce the corporate tax rate to 25 percent, allow full expensing of capital investments, and end international business tax deferrals while taxing foreign profits at one-third the difference between the U.S. and foreign corporate tax rates. In the short term, the plan would deem repatriation of previously deferred profits to be taxed at one-half the difference between the current U.S. rate of 35 percent and the applicable foreign tax rate, payable over a decade.

Anderson said the Tax Foundation estimated that the Hudson plan would result in economic growth of $2 trillion over a decade. The typical American would see benefits twice as large as the top 1 percent, according to the Tax Foundation’s scoring. And while the plan would provide a $1.1 trillion tax cut, over 10 years it would increase federal revenues by $679 billion “as a result of the taxes on the increased growth being greater than the lost revenue from the tax cuts themselves,” Anderson said.

‘Within the Realm of Reality’

“What’s good about this plan is that it makes a decision to try to present something that could be adopted,” said Alan D. Viard of the American Enterprise Institute. “It’s more than just tinkering. It occupies an intermediate space, which makes significant changes but not absolutely radical restructuring of the system.”

Given both the demands for revenue neutrality and continuing support for popular government programs, the Hudson plan does not propose marginal tax rate cuts of a magnitude contemplated by many GOP tax proposals, Viard noted. Nor does it substantially reduce what he called the “work disincentives” of the current tax system, he added. Nevertheless, noting that the plan reduces savings and investment disincentives with full expensing of capital investments, lower corporate tax and estate tax rates, and other changes, Viard said, “I think this plan measures up pretty well.”

Eric Toder, co-director of the Urban-Brookings Tax Policy Center, challenged a central assumption of the Hudson Institute’s plan, saying, “I think the tax system raises insufficient revenue. I think we’ve learned in this [presidential campaign] that Republican voters particularly don’t want to touch entitlements, don’t want to touch Social Security and Medicare. And we’re not going to be able to, with the aging of the baby boomers . . . get the deficit under control without higher taxes, unless we do something about Social Security and Medicare.”

The Hudson plan makes some progress in reducing what Toder called “gratuitous complexity” in the tax code by eliminating phaseouts and reducing the alternative minimum tax, although he questioned the continued need for the AMT under the Hudson plan, which removes the state and local tax deduction, reducing the amount the AMT would collect. Toder added that he likes the plan’s international tax reform components, although he said they do not resolve the trade-off embodied in the current U.S. hybrid territorial and international tax system. “On a positive note, this is certainly, unlike many of the other plans, one that’s within the realm of reality,” Toder said.

Who Cares?

Henry Olsen, senior fellow at the Ethics and Public Policy Center, said Republican tax reform plans should be geared less toward promoting growth and more toward resolving the GOP’s long-standing political problem.

“The broad Republican problem is that people know the Republicans care about money,” Olsen said. “They don’t know that [Republicans] care about life. So the Main Street Tax Plan, I think, needs to be measured in light of the degree to which it talks less about money and more about life, the way a person would perceive that. And on this, I think the Main Street Tax Plan has a number of great advantages over any of the tax plans that are being offered by any of the Republican presidential candidates.”

Eliminating the Medicare payroll tax would put more money into lower-income taxpayers’ pockets, Olsen said. Increasing the child care tax credit “tells people in the working class that we understand that raising children is something that’s expensive, is something that’s necessary, and we’re here to help you out,” he said, adding that the new 20 percent individual income tax bracket has a similar effect in showing lower-income taxpayers that the GOP recognizes their financial struggles.

Even cutting corporate rates and permitting full expensing “tells the average American that our priority is your priority, that we care about people like you, and we’re going to bring the people who help you out back home to America, rather than punitively allowing them — or actually kicking them out the door to go somewhere else,” Olsen said.

Toder said that when it comes to the particulars of tax reform — whether the Medicare tax should be reduced, or what the corporate tax rate should be — most American taxpayers are uninformed and tuned out.

“I think the public cares about the size of the tax burden, and they care about how big government is and how small government is,” Toder said. “But I
think when we start getting into the weeds, I don’t think we gain much by appealing to public opinion.’’

Correction: April 4, 2016: The original article misquoted Viard’s reference to the work disincentives he said were involved in the current tax system.

States Largely Ignored in Federal Tax Reform Plans, Panel Says

By Jonathan Curry — jonathan.curry@taxanalysts.org

Given the challenges of accomplishing any sort of tax reform at the federal level, policymakers often give little thought to the effects that their tax reform proposals will have at the state and local level, according to panelists speaking March 31.

“Tax reform doesn’t happen in a vacuum,” moderator Liz Farmer of Governing magazine said at a forum hosted by the Urban Institute State and Local Finance Initiative and the Urban-Brookings Tax Policy Center. Panelists agreed that the ripple effects of federal tax policies are not felt uniformly across the many state tax codes.

‘‘Tax reform doesn’t happen in a vacuum,’’ Farmer said.

A carbon tax, for example, would have a significantly greater effect on states that mine and produce carbon products, said Frank Sammartino of the Tax Policy Center. Likewise, proposals to eliminate the federal deduction for state and local taxes would recoup nearly $500 billion in federal revenue over the next five years, but ending the deduction would have a disproportionately stronger effect on states that have high income taxes, particularly in Northeastern states like New York. “It’s a blue-state, red-state thing,” he added.

According to Sammartino, states will respond to an increase or decrease in their revenues, and places like California have responded to the state and local tax deduction, which he called a “subsidy to state and local governments,” by raising taxes on their high-income taxpayers, knowing that most state and local tax deductions are claimed by taxpayers with incomes over $100,000. The state tax increase would be largely offset by the federal tax deduction, he said. A March 31 report by the Tax Policy Center examines the effect that eliminating the state and local tax deduction would have on the revenue and spending of state and local governments.

State and Federal Taxes Linked

Jeffrey Friedman of Sutherland Asbill & Brennan LLP said that states often “hitch their wagons” to federal tax policy, which benefits the states by simplifying the administration of their own tax codes and saves them from having to design rules. State constituents tend to prefer conformity between federal and state tax codes because it makes filing tax returns simpler, he said.
Friedman added, however, that the federal government does not have to balance its budget and can use deficit spending to enact expensive tax policies, while state budgets are more limited and may require balancing under a constitutional mandate.

The bottom line for senior elected officials is how a federal tax proposal will increase or decrease revenue, said Scott Pattison, executive director and CEO of the National Governors Association.

Pattison stressed the importance of tax-exempt municipal bonds for states, adding that proposals to modify tax-exempt bonds are seen less as a tax reform debate and more as an infrastructure debate. If Congress does not raise gas taxes, municipal bonds will continue to be a “critical component of infrastructure funding.”

Elizabeth McNichol, senior fellow at the Center on Budget and Policy Priorities, said that while it seems states are often ignored in the federal tax reform debate, there are some reasons to be optimistic, citing cooperation between state and federal agencies on issues like the earned income tax credit.

Proposals

The panelists weighed in on various tax proposals ranging from those of the presidential candidates to more specific policies.

Friedman said a VAT would probably be an improvement over the current system, adding that the sales tax used by many states is inefficient because it taxes sales between businesses. He also said he didn’t think a VAT-style tax, like the one proposed by Republican presidential candidate Sen. Ted Cruz of Texas, would be enacted at the federal level.

McNichol cautioned that sweeping tax reform proposals, such as replacing the income tax with a VAT, would interfere with the ability of states with sales and use taxes to continue collecting those taxes. On average 30 percent of state budgets are funded with federal revenue, and any efforts toward revenue-neutral tax reform and deficit reduction would likely shrink state budgets, she said.

Sammartino warned against plans like the one offered by Democratic presidential candidate Sen. Bernie Sanders, I-Vt., to raise the tax rate on capital gains to around 64 percent. “Raising tax rates squeezes the states,” he said, adding that significant tax increases could result in the federal government engaging in “tax cannibalism,” when it begins to eat into its own tax base.

Pattison and Friedman agreed that states are looking for Congress to vote on the Marketplace Fairness Act. Friedman said states and large businesses like Amazon largely support the act, and that even opponents who talk of “fixing” it acknowledge some type of legislation is needed.

No Action on Comprehensive Tax Reform in 2016, Survey Says

By Dylan F. Moroses — dylan.moroses@taxanalysts.org

Divided government will continue to gridlock Congress, preventing any meaningful tax legislation this year, according to an annual tax survey produced by the National Foreign Trade Council and Miller & Chevalier Chtd. and released March 30.

“None of this year’s respondents believe tax reform will happen,” according to the report, compiled by surveying top industry stakeholders on their thoughts on the prospects for tax action in 2016.

The survey results point to the current political landscape, in which lawmakers are discussing tax policy and reform but little action is being taken, with an administration unwilling to pass legislation for the short term, said Marc J. Gerson, vice chair of the tax department at Miller & Chevalier. “There is a view that Congress has tried, but it’s not a priority for the [Obama] administration,” Gerson told Tax Analysts. Gerson formerly served as majority tax counsel to the House Ways and Means Committee.

Gerson said he believes that the next president, from either party, could have a pivotal role in prioritizing and eventually enacting tax reform, citing President Reagan’s influence in passing the Tax Reform Act of 1986. “Tax reform being made a top priority of the new administration would be a game changer to the dynamics of tax reform and its prospects for enactment,” Gerson said.

‘When the executives surveyed by Miller & Chevalier talk about tax reform, they mean something very different: substantial tax cuts for themselves,’ Gardner said.

Republicans dominate as far as which presidential candidate respondents viewed as having the most favorable tax policy for business income, but two of the top three — former Florida Gov. Jeb Bush and Sen. Marco Rubio, also of Florida — have dropped out of the race (real estate developer Donald Trump placed second). Nearly 80 percent of respondents thought Democratic candidate Sen. Bernie Sanders, I-Vt., would have the worst tax policies for business income. Former Secretary of State Hillary Clinton, the Democratic front-runner, placed second at approximately 11 percent.

Matthew Gardner, executive director for the Institute on Taxation and Economic Policy, said the
survey was essentially created by executives for executives. “It’s hardly surprising that corporate leaders would say Republicans offer the best shot at tax reform — but really that just speaks volumes about what corporate leaders think tax reform means,” Gardner told Tax Analysts. “When the executives surveyed by Miller & Chevalier talk about ‘tax reform,’ they mean something very different: substantial tax cuts for themselves.”

Corporate taxes in the United States are “so low, as a share of the economy, compared to other nations, that a basic benchmark for sensible corporate tax reform should be revenue neutrality,” something Republicans have historically not supported, Gardner said.

Chris Edwards, director of tax policy studies at the Cato Institute, said the OECD’s base erosion and profit-shifting project has resulted in challenges for corporations. “The survey reveals that today’s tax executives have a more complex political climate to operate within because negative tax rules can come from many different levels of government,” he said.

The survey also found that businesses are most concerned with rates being reduced and with “the enactment of revenue-raising provisions without offsetting tax rate reductions.” Most executives think tax reform should involve a top corporate statutory rate between 25 and 28 percent and a top individual rate of 35 percent, according to the survey results.

Edwards said he found it interesting that reducing statutory rates “was far more important than simplifying the tax code.” Nearly 46 percent of respondents said rate reduction was the most significant issue to address through tax reform, compared with just 14 percent saying code complexity was.

“Liberal tax critics often talk as if corporations can pay whatever rate they want because there are supposedly so many loopholes in the tax code. If that were true, then these tax executives wouldn’t care about the statutory rate that much,” Edwards said.

Moreover, a majority of survey respondents believe Congress is again heading to a tax extenders measure at the end of the year to incorporate some of the provisions that were not made permanent in the 2015 deal (P.L. 114-113). However, just over half of the survey respondents believe it will come after those provisions expire.

The survey also found that House Speaker Paul D. Ryan, R-Wis., is easily considered the most influential figure in tax policy in 2016, followed by House Ways and Means Committee Chair Kevin Brady, R-Texas, and President Obama.

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**IRS CHASTISED OVER DELAY IMPLEMENTING HEALTH COVERAGE TAX CREDIT**

Brown and Portman said it is “entirely unacceptable” for the IRS not to meet the legal deadline for the advance payment program. “Many of our constituents have already had to take out home equity lines of credit, withdraw money from retirement accounts early, or take other extraordinary measures to pay for health insurance while the IRS gets the [advance monthly payment] program up and running,” they said.

They also said it was unfair for the IRS to give “taxpayers little notice that they won’t be receiving any premium assistance for the second half of the year — when many are already locked into health insurance plans with set payments.”

IRS Commissioner John Koskinen, in written testimony to a March 8 hearing of the Senate Appropriations Financial Services and General Government Subcommittee, told lawmakers that the reauthorization of the credit was one of several unfunded legislative mandates added to the IRS’s workload during a time of limited resources. (Prior coverage: Tax Notes, Mar. 14, 2016, p. 1240.)
Ryan’s Comments on Distribution Draw Range of Responses

By Dylan F. Moroses — dylan.moroses@taxanalysts.org

House Speaker Paul D. Ryan, R-Wis., sparked various responses from lobbyists and tax scholars after saying in a recent interview that he does not believe that policy proposals should be influenced by distributional tables, which depict how the tax burden is dispersed among income groups in the United States.

“I do not like the idea of buying into these distributional tables. What you’re talking about is what we call static distribution. It’s a ridiculous notion,” Ryan told John Harwood of CNBC on March 17. “What it presumes is life in the economy is some fixed pie, and it’s not going to change. And it’s really up to government to redistribute the slices more equitably. That is not how the world works. That’s not how life works. You can shrink or expand the economy, and what we want to maximize is economic growth and upward mobility so that everybody can get a bigger slice of the pie.”

William Signer, executive managing director of the Carmen Group, told Tax Analysts that Ryan was accurate about the use of distributional tables, but the perception of inequality poses problems for the Republican Party and its opponents during an election year.

“While Ryan is correct — distribution should not be static, and things change — there would be an optics issue if revenue neutrality resulted in those with higher income brackets having a significantly lower tax burden as a result of reform,” Signer said, adding that “this has been an issue for both sides during the campaign.”

‘By raising the notion of “static distribution,” Ryan describes the growth and distribution effects of tax policy as if they are the same thing. They are not,’ Gleckman said.

Howard Gleckman of the Urban Institute said in a March 23 blog post for the Urban-Brookings Tax Policy Center that Ryan “cleverly conflates two ideas: By raising the notion of ‘static distribution,’ he describes the growth and distribution effects of tax policy as if they are the same thing. They are not.”

Chris Edwards, director of tax policy studies at the Cato Institute, told Tax Analysts that Congress should encourage incorporating distributional tables that include growth effects based on tax changes, commonly referred to as dynamic scoring. Edwards said static distributional tables pose problems because the resulting data can easily be manipulated to serve a stakeholder’s best interest.

Data issued by organizations like the Tax Policy Center are in the form of static distributional tables, based on a “slice in time,” but some agencies, including the Congressional Budget Office, have the ability to include the growth changes, Edwards said, adding that static tables and lifetime distribution tables can show very different pictures of economic growth, especially related to consumption-based taxes.

“Consumption-based taxes look very bad on these slice-in-time distribution tables, but actually seem successful in distribution tables over a lifetime,” Edwards said.

Matthew Gardner, executive director of the Institute on Tax and Economic Policy, said that while the arguments between static distribution over a lifetime and dynamic scoring are the heart of the issue, static analysis “gets right to the heart of claims that lawmakers are pitching when proposing tax breaks. Policymakers focus primarily on who gets the tax cut.”

“Static distributional tables are the bedrock of economic analysis for tax plans,” Gardner said. “Anything else is speculative at best, and more often worse.”

Ryan’s disregard for static analysis, which the Institute on Tax and Economic Policy relies on for its research, makes his comments on seriously imprecise, Gardner said.

“You can’t evaluate the long-term effects without having a grip on the short term. It matters a lot who you give tax cuts to right now,” Gardner said.

Jared Bernstein of the Center on Budget and Policy Priorities, in a March 18 op-ed in The Washington Post, criticized Ryan’s view on distributional tables and his promoting of a traditional conservative policy in which the wealthy shoulder a lesser portion of the tax burden.

“In this regard, distributionally neutral tax plans are actually a low bar. What many would like to see is more progressive tax reform to offset some of the increase in pretax inequality,” Bernstein wrote. “We can argue whether that’s a reasonable desire, but I find it very hard to argue a) what people really want is the opposite: more regressive tax plans, or b) families would be better off if they didn’t know the impact of tax proposals on their incomes.”

James Pethokoukis of the American Enterprise Institute was also critical of the House speaker in a March 18 guest column in The Week that addressed the rise of Republican presidential candidate Donald Trump. “Not only does Ryan’s position [on
significant tax cuts for the wealthy] clash with the Trumpist truths of 2016 — his position makes little sense from a policy standpoint,” Pethokoukis wrote. That type of policy affirms the idea that the Republican Party leadership is disconnected from voters and has allowed a “populist candidate” like Trump to command the race for the GOP presidential nomination, he added.

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**Roskam to Continue Oversight’s Push for Asset Forfeiture Reform**

*By Kat Lucero — kat.lucero@taxanalysts.org*

When Rep. Peter J. Roskam, R-Ill., investigated the IRS’s civil asset forfeiture policy, he told agency officials they were just like Javert from *Les Misérables*.


The IRS was operating in a similarly uncompromising manner through its forfeiture program, according to the chair of the House Ways and Means Oversight Subcommittee, a key watchdog post with jurisdiction over federal tax administration.

For years the IRS had unfairly seized people’s bank accounts, Roskam said. It had accused small business owners of “structuring,” a serial practice often tied to criminal syndicates that involves keeping financial transactions under $10,000 to avoid the reporting requirements of the Bank Secrecy Act.

As a result of the subcommittee’s work, the IRS changed its policy to pursue only cases with signs of wider criminal activity. The IRS also returned over $150,000 to a North Carolina store owner after determining that the funds had been wrongly confiscated, according to a February 19 release from the Institute for Justice. (Prior coverage: Tax Notes, Feb. 16, 2015, p. 869.)

But Roskam wants to do more for individuals who had assets confiscated under the IRS’s old policy. That is why he is working on legislation that would force the IRS to review older cases and return assets it took from small business owners, specifically targeting the IRS’s policy on structuring, the lawmaker said. The legislation would be in contrast to broader measures such as the Fifth Amendment Integrity Restoration Act (S. 255), introduced in January 2015, which would require a court hearing within 14 days regarding any property seized as a result of an alleged structuring violation. (Prior coverage: Tax Notes, Feb. 2, 2015, p. 587.)

Roskam and the subcommittee’s ranking minority member, Rep. John Lewis, D-Ga., requested in a March 23 letter that the IRS, Treasury, and the Justice Department review all civil asset forfeiture cases, appropriately remit funds, and give due consideration to all pending petitions. The letter was signed by all members of the subcommittee.
and follows up on a similar request from August 2015. (Prior coverage: Tax Notes, Mar. 28, 2016, p. 1524.)

IRS Commissioner John Koskinen, however, pushed back March 23, arguing that the IRS has already changed its structuring policy after the subcommittee put a spotlight on some unwarranted cases. He said the agency would review cases if requested and that the bulk of them are judicial cases under the domain of the Justice Department, not the IRS.

Small business owners didn’t realize ‘they were running afoul of a technical banking statute, and all of a sudden the IRS shakes them down,’ Roskam said.

Early in 2015 Roskam launched an investigation and held hearings on civil asset forfeiture. He said the inquiry revealed wrongful convictions that “made no sense whatsoever from an actual justice point of view,” because there was no underlying criminal case. The cases involved small business owners who didn’t realize “they were running afoul of a technical banking statute, and all of a sudden the IRS shakes them down,” he said, adding, “This is not a meth lab. It’s not a human trafficking operation.”

The full Ways and Means Committee considered the work on civil asset forfeiture as one of its major wins in 2015. Koskinen apologized before the Oversight Subcommittee for the IRS’s past mistakes and remitted funds to a few affected individuals. The IRS and the Justice Department also changed their policies so that they would pursue only cases with signs of criminal activity.

Not Always Bipartisan

While the subcommittee’s ongoing work on civil asset forfeiture reform has been hailed as bipartisan, some critics say the rest of Roskam’s projects tend to be politically driven. Oversight Subcommittee member Joseph Crowley, D-N.Y., told Tax Analysts that although he has a good working relationship with Roskam, some of his hearings have been on issues “that I don’t really see as moving legislation.”

Roskam received some criticism at the March 3 subcommittee hearing about free speech on college campuses. Lewis in his opening statement immediately questioned the hearing’s purpose. “Mr. Chairman, I do not understand why we are here,” Lewis said, noting that the subcommittee does not oversee freedom of speech, college curriculum, or school resources. Some of the witnesses’ testimony at the hearing was better suited for hearings in other House committees, Lewis said. (Prior coverage: Tax Notes, Mar. 7, 2016, p. 1103.)

In the interview, Roskam defended his motives. “These speech issues are obviously sensitive and can be misinterpreted. If an institution like Georgetown law school is misstating the law, we’ve got a challenge on our hands,” he said.

While in law school, Roskam worked in his parents’ nonprofit organization, which provided college scholarships to thousands of students. The lawmaker claimed that he is not “an expert by any stretch of the imagination” in the area, but he said the experience gave him a deeper appreciation of the nonprofit sector. “Our civil society is inextricably linked to our strength as a nation,” Roskam said. “We absolutely need a thriving and dynamic civil society” that depends on section 501(c)(3).

One nonprofit-related win in 2015 for the subcommittee chair was the passage of his measure that permanently prohibited the IRS from imposing the gift tax on donations to some tax-exempt organizations, including those under section 501(c)(4). The House adopted it earlier in April and included it as part of the year-end tax and spending package (P.L. 114-113). (Prior coverage: Tax Notes, Dec. 21, 2015, p. 1451.)

Roskam served in the Illinois state legislature for over a decade. He was elected to Congress in 2006, replacing his mentor, former Rep. Henry Hyde. He has served on the Ways and Means Committee since 2009 and as Oversight Subcommittee chair since the beginning of the 114th Congress. He is also on the Health Subcommittee.

“As Ways and Means chairman, I worked closely with Peter on a number of oversight issues,” House Speaker Paul D. Ryan, R-Wis., said in a statement to Tax Analysts. “He has been a leader on everything from stopping IRS abuse to reining in Medicare fraud. I appreciate the seriousness and tenacity Peter brings to the subcommittee.”

Paying for Cybersecurity

While Roskam admits he is not an information technology expert, he said he does understand the “natural tension” between convenience and security when it comes to taxpayers accessing their personal information online. However, the days of easy access “may be an indulgence,” Roskam said, adding that ultimately the federal government may have to front-load its IT systems with more security. When asked if he would recommend allocating additional funding to IRS cybersecurity because of the latest attacks, the lawmaker said, “I wouldn’t presume that right now.”

The IRS has faced budget cuts since 2010, but last year Congress agreed to an additional $290 million for the agency for fiscal 2016 for the sole purpose of
improving customer service. Many lawmakers have resisted providing increased funding primarily because of the IRS’s political targeting controversy. Roskam, who took part in Congress’s investigation of the controversy, said the full committee continues to seek a “good assessment” of IRS spending. (Prior coverage: Tax Notes, Dec. 21, 2015, p. 1452.)

A Ways and Means Committee source said a hearing on IRS administration issues may take place near the return filing deadline.

Taxpayer Rights
Roskam has been an advocate for taxpayers he sees as victims of IRS abuse, sponsoring measures such as the Taxpayer Bill of Rights Act of 2015 (H.R. 1058), which also passed as part of the year-end tax and spending package.

Roskam attended a public forum held by the Taxpayer Advocate Service to get taxpayer input on the IRS’s ‘future state’ vision.

On March 9 Roskam attended a public forum in his congressional district with National Taxpayer Advocate Nina Olson, the second of several events across the country planned by the Taxpayer Advocate Service to get taxpayer input on the IRS’s “future state” vision. (Prior coverage: Tax Notes, Mar. 14, 2016, p. 1232.)

Roskam also attended a local volunteer income tax assistance clinic. He said the operation was “sophisticated” and met the needs of his constituents. “I was particularly impressed with the caliber of the volunteers. These were people who have background and training and technical expertise, and [a] willingness to walk [clients] through some very complicated situations.”

Oversight’s 2016 Agenda
For the rest of 2016, the Oversight Subcommittee will continue to work on last year’s investigations and initiatives, including preventing U.S. companies from benefiting from the potential waiver by the Obama administration of tax code provisions giving unfavorable treatment to income earned in Iran in light of the nuclear deal with that country, Roskam said. The subcommittee held a hearing on the issue in November 2015. (Prior coverage: Tax Notes, Nov. 9, 2015, p. 784.)

The subcommittee will also once again look at the favorable tax treatment of large university endowments, carrying on its investigation from last year, Roskam said, adding that he is awaiting a response from the IRS on an inquiry regarding endowments. (Prior coverage: Tax Notes, Oct. 12, 2015, p. 230.)

Taxpayer Advocate Schedules More ‘Future State’ Forums

By William Hoffman — william.hoffman@taxanalysts.org

Taxpayers and tax practitioners will get another chance to give the IRS and the Taxpayer Advocate Service (TAS) a piece of their mind when the TAS holds its fourth public forum on the IRS’s “future state” vision of technology-oriented taxpayer service in Hendersonville, North Carolina, on April 4, followed by another in Harrisburg, Pennsylvania, on April 8.

Rep. Mark Meadows, R-N.C., will attend the two-hour event in North Carolina, which the IRS officially announced (IR-2016-49) March 28. Meadows is a member of the House Oversight and Government Reform Committee and chair of the Government Operations Subcommittee.

Sen. Robert P. Casey Jr., D-Pa., a member of the Senate Finance Committee and ranking minority member of the Taxation and IRS Oversight Subcommittee, will attend the Pennsylvania forum.

The TAS is still finalizing plans regarding other locations, attending lawmakers, and panelists as it solicits comments nationwide about the IRS’s future state vision. The public forums could stretch into the summer. National Taxpayer Advocate Nina Olson launched the forums earlier this year over what she considered the IRS’s overreliance on technology solutions to its taxpayer service obligations. IRS Commissioner John Koskinen has a different view. (Prior coverage: Tax Notes, Feb. 29, 2016, p. 966.)

Koskinen told a group of IRS employees on a conference call March 28 that the agency is “very supportive” of the TAS’s public forums, the IRS told Tax Analysts. Koskinen spoke at the first TAS forum in Washington.

‘The IRS is considering input from a wide variety of sources for its continuing work and development of the Future State,’ the IRS said.

“The IRS is considering input from a wide variety of sources for its continuing work and development of the Future State,” the IRS said in a March 28 statement. “The Advocate’s sessions are another way of people providing insight into the taxpayer experience as we develop future state processes and services. We are monitoring the sessions as part of our efforts on the Future State.”
Lively Discussions

The first three TAS panels featured discussions with politicians, practitioners, and activists about problems with IRS tax administration, the consequences of those problems, and potential solutions.

“An agency fixated on efficiency and delivering services at the lowest possible short-term cost, without knowing the impact and burdens of its actions, may find itself pushing more serious problems down the road, while at the same time jeopardizing taxpayer rights,” said Leslie Book, professor at Villanova University School of Law, at the first TAS forum February 23 at IRS headquarters in Washington.

Andrew VanSingel, director of the low-income tax clinic at Prairie State Legal Services, said at the March 9 forum in Illinois, “If the IRS gets out of the business of talking to taxpayers through these traditional mediums, it will force some of our most vulnerable populations to pay someone just to comply with the tax laws. And it’s unknown if the Service will even have the authority to regulate these people that [taxpayers] are paying to help.” (Prior coverage: Tax Notes, Mar. 14, 2016, p. 1232.)

At the March 18 TAS forum in New York, Rep. José E. Serrano, D-N.Y., ranking minority member of the House Appropriations Financial Services and General Government Subcommittee, tied the IRS’s service problems to its budget woes. “Every time we have a budget cut, we have less services to give the taxpayer,” he said. “Taxpayers should be able to make a phone call and get somebody on the phone right away.” (Prior coverage: Tax Notes, Mar. 28, 2016, p. 1528.)

Final Anti-Loss Importation Regs Reject Most Recommendations

By Marie Sapirie — marie.sapirie@taxanalysts.org

Final regulations governing nonrecognition transfers of loss property to corporations under sections 334(b)(1)(B) and 362(e)(1) generally adopt the framework of the proposed regulations and address some commentators’ concerns, but most recommendations were rejected.

In the final regs (T.D. 9759), released March 25, several issues were reserved for future guidance projects, and others were described as being outside the scope of the regulation package. “The good news is we have final regulations now that can be relied on,” said Scott M. Levine of Jones Day.

The proposed regulations (REG-161948-05) under sections 334(b)(1)(B) and 362(e)(1), published in September 2013, provided rules for when the tax basis of built-in loss property would be reduced to fair market value upon an “importation” of the property from a person not subject to U.S. tax (generally, a non-U.S. or tax-exempt person) to a U.S. corporation in a transferred basis transaction.

To determine whether a transferor is subject to U.S. tax, the proposed regs included a look-through rule for some flow-through entities such as partnerships. The New York State Bar Association Tax Section submitted a report in 2014 on the proposed regulations that asked the government to reconsider the look-through rule for some widely held or publicly traded partnerships, citing the difficulty of administering the rule for those entities. The report also recommended tentatively dividing debt-financed property transferred by a tax-exempt entity under section 501(a) so that the transferor is notionally split into a taxable transferor and a tax-exempt transferor, thereby avoiding a cliff effect under which property subject to only a de minimis amount of indebtedness could entirely avoid classification as importation property subject to section 362(e)(1).

The final regulations confirm that the look-through approach applies to widely held or publicly traded partnerships, and the preamble notes that “the statute explicitly contemplates that partners, not partnerships, are the focus of the inquiry under section 362(e)(1).”

“I think people will be somewhat disappointed by the failure to deal with publicly traded and widely held partnerships,” said Stuart L. Rosow of Proskauer Rose LLP. “I understand why [the government] may feel constrained on that, but I’m not sure how [the rules are] really workable.”
The final rules do, however, treat debt-financed property as subject to federal income tax in proportion to the amount of the gain or loss that would be includable in the transferor’s unrelated taxable business income on a sale under sections 511 through 514. Rosow said the changes to the rules for tax-exempt transferors of debt-financed property are sensible. “While they may be more complicated to apply, it is sensible to say that when a tax-exempt entity transfers property that would be partially taxable as unrelated business or debt-financed property, to the extent it would be taxable, it is excluded from the loss imputation rules, but to the extent it isn’t taxable, it shouldn’t be excluded, rather than to have it as a cliff, as the proposed regulations did,” he said.

The preamble explains that in the context of a section 367(b) inbound liquidation or reorganization, “the final regulations affirmatively state that the basis reduction does not affect the calculation of the all earnings and profits amount.” Under the new rules, taxpayers are required to recognize the reg. section 1.367(b)-3 “all E&P” amount while also losing the built-in loss in the transferred assets, said Levine. That result can be harsh in many circumstances because “it seems unfair to require the pickup of the all E&P amount and also cause the taxpayer to lose its basis in the built-in loss asset. We think it’s duplicating the tax cost,” he said.

“I think people will be somewhat disappointed by the failure to deal with publicly traded and widely held partnerships,” Rosow said.

“E&P is generally tied to the basis of assets used in a business; as a corporation earns profits, it also expends costs that are capitalized into the basis of its assets,” Levine said. “In this sense, it’s unreasonable to tax a corporation on its E&P and also eliminate the basis created in the course of generating that E&P.” He noted that if the built-in loss asset had been sold immediately before the inbound transaction, the recognized loss would have reduced the all E&P amount.

**COMING REGS WILL ADDRESS REPORTING GAP IN FOREIGN-OWNED LLCs**

Treasury will soon issue proposed regulations requiring foreign-owned single-member limited liability companies to report their beneficial owners to the IRS and obtain taxpayer identification numbers, according to Robert Stack, Treasury deputy assistant secretary (international tax affairs).

According to a March 30 statement issued by Stack, the new requirements will be applied by treating those entities as corporations for purposes of section 6038A. The IRS included issuing the new regulations in its 2015-2016 priority guidance plan, released last year.

“As we announced when we released the Priority Guidance Plan last August, we have been working on and expect to release soon proposed regulations that will treat these foreign-owned single-member LLCs as corporations solely for purposes of reporting under Section 6038A of the Code. This will provide a mechanism for us to require the filing of an information return, which will therefore require these foreign-owned LLCs to obtain a [taxpayer] identification number and thereby disclose who their foreign owner is,” Stack said.

Although the U.S. federal tax information reporting system is generally strong, the coming regulations are necessary to address a gap in reporting requirements that allows “a narrow class of foreign-owned U.S. entities, typically single-member LLCs,” with specific types of income to avoid disclosure based on a lack of sufficient U.S. business activity or U.S. bank accounts, according to Stack. This may allow those entities to evade taxes or conceal their ownership, he said.

Stack said that although a change in the law is needed to fully resolve the issue of beneficial ownership, the new regulations will narrow the gap in reporting requirements. “Once these regulations are finalized, the IRS will be far better equipped to ensure that these entities are not facilitating U.S. tax avoidance and to respond to requests about these entities from other tax authorities as appropriate under our tax treaties and tax information exchange agreements,” according to Stack.

The United States faces growing international criticism over individual states’ business registration laws that allow domiciled LLCs to withhold the identity of their beneficial owners. The Financial Times (“Fear and Regulatory Loathing Makes America the Top Tax Haven”), Forbes (“The World’s Next Top Tax Haven Is... America”), Bloomberg BusinessWeek (“The World’s Favorite New Tax Haven Is the United States”), and The Economist (“The Biggest Loophole of All”) have all published pieces this year criticizing the United States for its lack of adequate disclosure requirements and its refusal to join the group of more than 90 countries adopting the OECD’s common reporting standard, despite having pressured other countries to implement the Foreign Account Tax Compliance Act. (Prior coverage: Tax Notes, Mar. 21, 2016, p. 1400.)

—— Ryan Finley
The new rules clarify that even if the tax basis in an asset is lost under section 362(e)(1), the asset is still treated as having a transferred basis for most federal income tax purposes. “This is a welcome clarification,” said James S. Wang of Jones Day. “For example, this will clarify that a transferee still gets a tacked holding period under section 1223 even when it receives an asset whose basis has been reduced to fair market value under section 362(e)(1).”

The government reserved some of the harder issues, particularly the interaction of the anti-loss importation rules with sections 362(e)(2) and 704(c)(1)(C). “I think that probably makes sense,” Rosow said. Integrating the loss imputation scheme with the loss duplication rules requires careful reflection, he added. The preamble says the government will try to integrate the three schemes when the proposed regs on section 704(c)(1)(C) are finalized.

The final regulations exhibit some caution on the government’s part regarding trusts or other pass-through entities as well as concern about allowing electivity in the rules. “I think these regs are somewhat cautious in that regard in trying to limit the taxpayer’s ability to manipulate, even if in some cases you may get funny results,” Rosow said.

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**IRS Plans to Issue Proposed Regs Defining REIT Congregate Care**

By Amy S. Elliott — amy.elliott@taxanalysts.org

The IRS plans to develop proposed regulations defining what real property qualifies as a congregate care facility for purposes of the real estate investment trust rules despite recent calls from the industry that guidance is not needed.

Labeling a property as a congregate care facility under section 856(e)(6)(D)(ii), and therefore a qualified healthcare property under section 856(e)(6)(D)(i), is important for a REIT, said Andrea Hoffenson, branch 2 chief, IRS Office of Associate Chief Counsel (Financial Institutions and Products), on March 30.

“Not getting it right can have pretty devastating consequences, so we do believe that guidance is needed to provide a standard definition of what is congregate care,” Hoffenson said at a conference in Washington sponsored by the National Association of Real Estate Investment Trusts (NAREIT). “We do expect this guidance to come out in a proposed format for notice and comment.”

The project first showed up on the 2015-2016 priority guidance plan, although the plan did not specify that it would likely take the form of regulations.

On March 23 NAREIT submitted a letter to the IRS and Treasury stating that healthcare REITs “have developed a good working understanding” of what — in the government’s eyes — constitutes a congregate care facility. “We do not believe that additional guidance is needed or merits priority attention,” NAREIT wrote.

Joseph G. Howe III of Arnold & Porter LLP told practitioners at the conference that in recent years, the IRS has issued at least three letter rulings (LTR 201509019, LTR 201429017, and LTR 201250019) concluding that some senior living communities constitute congregate care facilities.

Even though those rulings all dealt with age-restricted communities, “there may be things broader than that that fit within the definition of congregate care,” Howe said. If the IRS wants to expand the types of communities that might qualify as congregate care, it should still require a modicum of health-related services or wellness programs to maintain a level playing field, he said, adding,
“Otherwise we’re concerned that we could find out that something such as student housing, which also has some healthcare services on a campus, could be pulled into it inadvertently.”

The IRS has issued two letter rulings (LTR 201320007 and LTR 201317001) concluding that some correctional facilities (for example, prisons) don’t constitute congregate care facilities even though they provide some medical care to residents, Howe pointed out.

NAREIT is concerned that guidance in the form of regulations can be rigid and has asked that if the government insists on developing rules, that they be general in nature and contain an effective date provision that grandfathers the treatment afforded to existing facilities, Howe said. “We’d hate to find out that something today that we think is a qualified healthcare facility no longer satisfies it or vice versa,” he said. “If you do change the landscape, you can change the tax implications rather quickly.”

**Preferential Dividends**

Julanne Allen, assistant to the branch 3 chief, IRS Office of Associate Chief Counsel (Financial Institutions and Products), said the IRS has received several questions on the repeal of the preferential dividend rule contained in the 2015 extenders legislation, the Protecting Americans From Tax Hikes Act of 2015 (PATH Act), which became law as part of P.L. 114-113.

The rule was repealed for publicly offered REITs, defined as REITs required to file annual and periodic reports with the SEC. The change means that publicly offered REITs are no longer required to issue dividends pro rata, so that preferred dividends may now count toward the dividends paid deduction that reduces a REIT’s corporate federal income tax liability.

“We do understand that publicly offered REITs may still be impacted if they are shareholders of REITs that don’t qualify” as publicly offered, Allen said. She added that the PATH Act gave the IRS discretion to provide relief in some cases when a REIT issued a dividend that inadvertently ran afoul of the preferential dividend rule. She said the IRS is open to suggestions on whether guidance is needed in that area.

**‘Bad Boy’ Guarantee Memo**

Richard M. Lipton of Baker & McKenzie said NAREIT and the Real Estate Roundtable both contacted the IRS following its recent release of a legal memorandum (ILM 201606027) that suggests that the use of a so-called bad boy guarantee could cause a nonrecourse real estate loan to be treated as recourse. (Prior coverage: Tax Notes, Feb. 29, 2016, p. 971.)

If the conclusion in the memorandum is correct, REITs that provide financing to developers who issue carveouts similar to the bad boy guarantees in the memo will now have to allocate the liabilities away from their operating partnerships and to the developers, Lipton said.

“We’re all pressuring the IRS to withdraw [the memo] as soon as possible,” Lipton said. “This thing is just wrong, and it’s not particularly defensible. They have had meetings. They have said they are studying it. They are looking at putting out some clarifications at some point in time in the near future.”

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REIT Rule Missteps: Pay the Penalty or Bust the REIT?

By Amy S. Elliott — amy.elliott@taxanalysts.org

There are so many potential foot faults in the real estate investment trust rules that even a savvy REIT may accidentally fail a requirement. In extreme cases, a wayward REIT could be better off filing as a traditional C corporation without a REIT election rather than avail itself of a statutory relief provision requiring payment of a penalty.

In what would admittedly be an outlier situation, “you’re almost sometimes in a better position economically if you had just filed as a C corp. That seems to me at least to be a little bit disproportionate to the penalty to the crime,” Dianne Umberger of EY said March 31 at a conference in Washington sponsored by the National Association of Real Estate Investment Trusts.

Section 857(b)(5) states that if a REIT fails to meet either the 95 percent income test or the 75 percent income test due to reasonable cause and not willful neglect, it may nevertheless be treated as having satisfied those tests if it, among other things, pays a 100 percent tax on the net income attributable to the excess bad gross income as calculated by a formula prescribed in the statute.

Umberger asked IRS officials at the conference if there is any wiggle room in coming up with a different amount. “It seems like it would be overly harsh to pay out a gross amount of money, where if we were a C corp, we’d actually pay less tax. Would you consider that in formulating an appropriate toll charge to a closing agreement?” she asked.

Peter J. Genz of King & Spalding said the IRS could simply tell that REIT that it didn’t have reasonable cause so that the section 857(b)(5) penalty isn’t even available. “We’re now a taxable C corp instead of just a busted REIT that’s still a good REIT but has to pay a penalty. That’s sort of perverse,” he said. A busted REIT technically has to wait five years before it can make another REIT election.

But Les Honig, senior program specialist (Northeastern compliance practice area), IRS Large Business and International Division, indicated that such an option isn’t as extreme as it sounds. “If you bust yourself, you could probably do that if you want to show you’re not reasonable. But then you have the issue of how soon you could re-REIT yourself,” he said. “In theory you might end up busted for one year and have permission to re-REIT in a subsequent year.”

Umberger asked if the IRS would give permission to do so in a closing agreement. Honig said it could but reminded her that the busted but re-REITed REIT will still incur a built-in gains tax at the highest corporate rate on any property sold by the REIT within five years.

David Silber, IRS deputy associate chief counsel (financial institutions and products), was skeptical of REITs seeking a more appropriate toll charge, pointing out that the IRS is compelled to follow the statute. “It’s not as if we can look at the statute that gives you what the penalty is and say we think that’s too high and just do a closing agreement and come up with some other number. We follow the law in the closing agreement,” he said.

Silber added that it isn’t just officials within LB&I who have jurisdiction to enter into closing agreements. In some circumstances, officials within his office can do that as well, even for cases involving filed returns, he said.

Honig pointed out that LB&I’s reorganization into nine practice areas has not resulted in a centralized group that just handles REIT closing agreements. “Everyone in the IRS is working consistently,” he said. “We all approach these the same way, so your REIT should be handled the same way no matter where it’s located geographically, he said.

Honig emphasized that IRS Exam doesn’t have settlement authority. If there are arguments on both sides of a REIT disqualification case, “we take a position and we say, ‘If you disagree, we can assess you, and you can go to Appeals,’” he said.

Genz said if the case involves an issue that’s not free from doubt and Exam can’t compromise, “then Exam’s going to call it up or down, and there’s a chance they could call it up — we won’t pay a penalty but still get a closing agreement that resolves this issue with finality.”

Reasonable Cause

Honig said that in 2011 the instructions to Form 1120-REIT, “U.S. Income Tax Return for Real Estate Investment Trusts,” were changed to require that a reasonable cause statement be attached to the Form 1120-REIT at the time it’s filed for failures involving the asset test, the gross income test, “or other qualification requirements under sections 856-859.”

He said that in 2012 the “or other” language was dropped from the instructions for some reason but that it should return to the 2016 instructions.

“There is no prohibition on putting a reasonable cause statement on a return,” Honig said, adding that he thinks the inclusion “is probably good practice.”

Genz said that in 1995 the IRS issued a letter ruling (LTR 9550019) concluding that a REIT’s failure to satisfy section 856(c)(2) was due to reasonable cause and not to willful neglect. He wanted to know why the IRS isn’t willing to issue those rulings.
today, given that they would seem to mirror the kind of determinations required to grant so-called 9100 relief — reg. section 301.9100 relief for foot faults involving regulatory elections. “These kinds of busts . . . occur with regularity, and many of them are mistakes. They’re not abusive behavior,” he said.

“There is no prohibition on putting a reasonable cause statement on a return,” Honig said, adding that he thinks such an inclusion “is probably good practice.”

Rev. Proc. 2016-3, 2016-1 IRB 126, states that the IRS won’t issue rulings on whether reasonable cause “or other similar terms that require a factual determination exist.”

Silber said the 1995 ruling was an anomaly. “Reasonable cause is a different standard altogether than the 9100 standard,” he said, adding that reasonable cause “is very much based on facts.”

Umberger said that even though reasonable cause isn’t required for 9100 relief, “whenever we file [for 9100 relief], we usually try to set forth those kind of circumstances that basically would amount to reasonable cause.”

Genz said the IRS has an interest in ruling on reasonable cause, because the status quo creates a “no man’s land.” Today, if an attorney won’t give an opinion that a REIT has reasonable cause for its foot fault, the REIT has little choice but to seek a closing agreement — or maybe just fire the lawyer and find one who will, he said.

Tax Policy Becomes Uncommon Cause for Rock Band

By William R. Davis — william.davis@taxanalysts.org

During the first night of a two-night sold-out stay at Washington’s 9:30 Club, Brooklyn-based Lake Street Dive used a break between songs to encourage the crowd to learn about high-income earners using offshore tax havens to avoid taxes. You read that right — a popular rock band was discussing taxes during a show.

The band has partnered with Oxfam America, a nonprofit organization that works on poverty, hunger, and injustice issues, to help promote its campaign against tax havens. Oxfam works with many musicians — such as Radiohead, Coldplay, and Angélique Kidjo — on a variety of issues. Oxfam told Tax Analysts that Lake Street Dive is among the first musicians to support the nonprofit on its campaign. Bands such as Ra Ra Riot and Thao & The Get Down Stay Down will soon follow, Oxfam said.

“Oxfam has a long history of working with social-justice-minded music artists like Lake Street Dive,” said Ferguson.

“Oxfam has a long history of working with social-justice-minded music artists like Lake Street Dive,” said Bob Ferguson, Oxfam America’s manager of creative alliances and music outreach. “We know that when a band speaks from the stage about an issue we are working on together, like our current inequality campaign, we can all make a difference. At Oxfam, we truly believe that music can change the world.”

Musicians have always been at the leading edge of the fight for social justice, but tax policy has never been a popular topic. If Ferguson is correct in arguing that musicians can inspire change, is Lake Street Dive’s support of fighting tax avoidance the beginning of a larger social shift in consciousness about tax issues?

Lake Street Dive, founded in 2004 while its members were students at the New England Conservatory of Music in Boston, has a growing fan base — giving it a larger platform for its anti-tax-haven work. The band performs a hybrid of non-edgy pop and soul. It is driven by singer Rachael Price, who is backed up by stand-up bassist Bridget Kearney; guitarist, trumpeter, and keyboardist Mike Olson; and drummer Mike Calabrese. The band’s most recent album, Side Pony, is on the top
THE BIRDS AND BEES — AND TAXES

It’s not news that taxes and the IRS are generally unpopular in America, but a recent survey by Wallet-Hub reveals that taxpayers are so uncomfortable filing their returns, that many of them would rather have “the talk” with their children.

The results come from WalletHub’s 2016 online survey of 1,000 taxpayers nationwide. In a question about what taxpayers would be willing to do if they could avoid paying taxes forever, 27 percent of respondents said they would get an IRS tattoo, 8 percent said they would name their first-born child “Taxes,” and a worrying 4 percent said they would kill someone for a tax-free life — if they could get away with it.

Another question about what taxpayers would prefer to do instead of prepare their tax returns reveals that household chores are far more appealing (77 percent would be more willing to do laundry, and 60 percent would rather mow the lawn) and that children would become more knowledgeable (48 percent would prefer to teach their kids how to budget, and 35 percent would rather talk to their kids about sex). Spending a night in jail was more appealing for 13 percent.

Other survey results seem to portray taxpayers in a nobler light. Eighty-one percent said they would not hide money offshore, even if they knew they would not be caught. And although more than half of respondents thought their tax rates were too high, 36.3 percent thought the amount of taxes they paid was just right, and another 5.1 percent thought they ought to pay more in taxes.

Asked whom they would most like to punch, Republican presidential candidate Donald Trump was the decisive winner of the vote at 52 percent, while “an IRS agent” was the top choice of only 4 percent of respondents. And only 14.4 percent said the IRS should be abolished.

The survey caught the attention of IRS Commissioner John Koskinen. In March 24 remarks at the National Press Club, Koskinen mentioned that the survey found that for some respondents, Russian President Vladimir Putin was more popular than the IRS. Koskinen acknowledged that the IRS won’t be winning any popularity contests, then added, “But don’t look for a shot of me on CNN, without a shirt, riding a horse.”

— Jonathan Curry
banks and brokers that discover, through money laundering due diligence, that the beneficial owner of a foreign account is a U.S. taxpayer to disclose that information to the IRS.

The bill would require investment advisers and corporate formation agents to establish anti-money-laundering procedures (31 U.S.C. section 5312). Investment advisers would be required to submit suspicious activity reports. The bill would also penalize jurisdictions and financial intermediaries found to be significantly impeding U.S. tax enforcement by preventing them from using U.S. correspondent accounts (31 U.S.C. section 5318A). A companion bill was introduced in the House. (Prior analysis: Tax Notes, Mar. 16, 2015, p. 1295.)

"The tax burden is falling on ordinary people, while the richest companies and individuals pay too little," the Oxfam report says.

Ultimately, Oxfam and its partnering musicians are calling on world leaders to agree on a global approach to end the era of tax havens. "The tax burden is falling on ordinary people, while the richest companies and individuals pay too little. Governments must act together to correct this imbalance," the report says.

Musicians and Policy

Musicians have a long history of acting as marketing arms for nonprofit organizations. Revolutions Per Minute (RPM) is a San Francisco-based nonprofit organization that provides musicians with strategy and support for their activism and philanthropy. RPM will also match up musicians with nonprofit organizations based on the bands’ interests.

RPM told Tax Analysts that it does not have any artists working on tax campaigns. Although there isn’t much history between tax advocacy and rock-and-roll, there are success stories that could provide optimism for Oxfam’s effort.

In 2009 California — faced with a fiscal crisis — had decided to cut $16 million in funding for domestic abuse services. The artist Moby decided to donate all of the profits from two sold-out concerts in California to a domestic abuse organization and worked with the California Partnership to End Domestic Abuse. Moby was able to raise awareness, and the California State Legislature eventually reinstated the $16 million funding.

Since 1985, Farm Aid has been putting on an annual benefit concert, working with local, regional, and national organizations to promote fair farm policies. Through its advocacy efforts, tens of thousands of petitions have been delivered to the secretary of agriculture.

Performance and songwriting have also proven to be powerful ways for musicians to make an impact, as Lady Gaga did when she co-wrote the song “Til It Happens to You” for the documentary The Hunting Ground, which raised awareness about sexual assault on college campuses. The song was nominated for a Grammy and an Academy Award, and Lady Gaga gave a critically acclaimed performance at the Oscars that was introduced by Vice President Joe Biden.
Transfer Pricing Roundup

By Ryan Finley — ryan.finley@taxanalysts.org and Kristen Langsdorf — kristen.langsdorf@taxanalysts.org

Albemarle Corp.

Jurisdiction(s): Undisclosed

Albemarle Corp., a chemical company headquartered in Baton Rouge, Louisiana, reported in a March Form 10-K that its liabilities regarding uncertain tax positions were reduced by $50.9 million in 2015 and $22.1 million in 2014 because of offsetting benefits due in part to the effects of potential transfer pricing adjustments.

Allergan PLC

Jurisdiction(s): United States

Allergan PLC, a global pharmaceuticals company headquartered in Dublin, reported in a February Form 10-K that on December 29, 2015, the IRS and Warner Chilcott Corp. agreed to amend the terms of its advance pricing agreement to end in 2015 rather than 2017. Allergan said it believes its transfer pricing arrangements still comply with existing tax rules.

AmTrust Financial Services Inc.

Jurisdiction(s): Undisclosed

AmTrust Financial Services Inc., a property and casualty insurance company based in New York, reported in a February Form 10-K that during 2015, its provision for income tax benefited from a return to provision adjustment during the third quarter of approximately $80 million. The return was driven primarily by changes to permanent transfer pricing tax adjustments.

Baxter International Inc.

Jurisdiction(s): United States

Baxter International Inc., an American healthcare company headquartered in Deerfield, Illinois, reported in a February Form 10-K that factors adversely affecting its effective tax rate in 2015 included charges related to contingent tax matters regarding transfer pricing and the separation of its biopharmaceuticals business, Baxalta.

Denali Holding Inc.

Jurisdiction(s): Undisclosed

Denali Holding Inc., a Delaware holding company for Dell Inc., reported in a March Form S-4/A that as of January 29, its accrued interest and penalties were $950 million, offset by tax benefits of $372 million from transfer pricing, interest deductions, and state income tax.

Marriott International Inc.

Jurisdiction(s): United States

Marriott International Inc., a hospitality company and hotel chain headquartered in Bethesda, Maryland, reported in a February Form 10-K that it recorded a $14 million increase in 2015, largely attributable to a U.S. federal tax issue regarding transfer pricing. The company said it believes it is reasonably possible that during the next 12 months it will resolve the issue for 2014-2015, for which it has an unrecognized tax balance of $15 million.

Mosaic Co.

Jurisdiction(s): Undisclosed

Mosaic Co., a specialty products mining company headquartered in Plymouth, Minnesota, reported in a February Form 10-K that it received a benefit of $14.5 million primarily for changes in estimates associated with an advance pricing agreement.

SL Industries Inc.

Jurisdiction(s): China, United States

SL Industries Inc., an American manufacturing company headquartered in Mount Laurel, New Jersey, reported in a March Form 10-K that its effective tax rate from continuing operations during 2015 decreased from 33 percent to 31 percent from 2014, partially due to a favorable settlement with the U.S. Treasury regarding the company’s transfer pricing policies in China.

Voltari Corp.

Jurisdiction(s): India

Voltari Corp., a commercial real estate business based in New York, reported in a March Form 10-K that in 2016 it received notification of a tax assessment from the Indian tax authorities asserting underreported transfer pricing income by the company’s subsidiary, Motricity India Pvt. Ltd., for the fiscal year ended March 31, 2012. The assessment could result in tax, penalties, and interest totaling approximately $400,000.

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Final Anti-Loss ImportationRegs
Generally Adopt Proposed Rules

By Joseph DiSciullo — joseph.disciullo@taxanalysts.org

Final regulations (T.D. 9759) under sections 334(b)(1)(B) and 362(e)(1) apply to some nonrecognition transfers of loss property to corporations subject to specified federal income tax. The anti-loss importation provisions were added by the American Jobs Creation Act of 2004 to prevent erosion of the corporate tax base when a person transfers property to a corporation and the result would be an importation of loss into the federal tax system. (Related coverage: p. 44.)

Effective March 28, the final regs adopt, with some changes and clarifications, the proposed regs (REG-161948-05) issued in September 2013. The regs also adopt, in part and without change, the proposed regs (REG-163314-03) issued in March 2005 that included amendments to the regulations under sections 332 and 351 to reflect statutory changes. The regs make nonsubstantive changes to the final regs (T.D. 9633) issued in September 2013 under sections 362(e)(2), 705, and 1367 to conform the terminology to that adopted in the new final regs and to correct errors and clarify cross-references.

The 2013 proposed regs provided specific rules to implement the statutory framework of the anti-loss importation provisions, such as rules for identifying importation property and for determining whether the transfer of that property occurs in a transaction subject to the anti-loss importation provisions. The final regs generally adopt the provisions of the 2013 regs, with some changes and clarifications in response to comments. Most of the comments addressed issues involving partnerships.

Under the 2013 proposed regs, the determination of whether gain or loss on property transferred by a partnership is subject to federal income tax would be made by reference to the treatment of the partners, taking into account all partnership items for the year of a section 362 transaction. The final regs do not allow the use of a closing of the books method and clarify that a partnership agreement, as well as any applicable rules of law, is considered in determining to which partner an item would be allocated and thus its federal income tax treatment. Treasury and the IRS rejected a suggestion that widely held partnerships and publicly traded partnerships not be subject to the look-through rule applicable to all partnerships.

The final regs do not adopt suggestions to make changes to strengthen the antiavoidance rule, as well as changes regarding foreign non-grantor trusts and trusts with no distributable net income. The final regs modify the rule in the proposed regs that if a tax-exempt entity transferred debt-financed property, the disposition of that property would be subject to federal income tax, and thus could not be importation property. The final regs adopt an approach that treats debt-financed property as subject to federal income tax in proportion to the amount of gain or loss that would be includable in the transferor’s unrelated business taxable income on a sale under sections 511 through 514. The regs provide that portions of property determined under this rule are generally treated under the anti-loss importation provisions in the same way as portions of property tentatively divided to reflect multiple owners of gain or loss on the property.

The final regs do not adopt a suggestion regarding the effect of a basis reduction required under section 334(b)(1)(B) or 362(e)(1) on earnings and profits and any inclusion required by reg. section 1.367(b)-3, affirming that the basis reduction does not affect the calculation of the all-earnings-and-profits amount. The final regs provide that despite the application of the anti-loss importation or anti-duplication provisions to a transaction, the transferee’s basis is generally considered to be determined by reference to the transferor’s basis for federal income tax purposes. However, when determining the adjustment to the basis of partnership property under section 755 when a partnership interest is transferred in a loss importation transaction, the transferee’s basis in the interest will be treated as not determined by reference to the transferor’s basis.

The final regs clarify that if the anti-loss importation provisions applied to a transaction, other provisions of law would continue to apply. The regs also make other changes to clarify the purpose and scope of some cross-references, as well as nonsubstantive corrections and clarifications suggested by commentators.

The final regs are applicable to transactions occurring after March 27, unless completed under a binding agreement that was in effect before March 28. The final regs also apply to transactions occurring before March 28 resulting from entity classification elections that are filed after March 27.
Taxpayers may apply the rules to any transaction occurring after October 22, 2004.

**Transportation Excise Taxes**

Proposed regulations (REG-103380-05) reflect legislative changes and court decisions on the excise taxes imposed on the sale of highway tractors, trailers, trucks, and tires; the definition of highway vehicle for purposes of those taxes and others; and the use of heavy vehicles on the highway. The regs provide an opportunity for comment on provisions of several sets of temporary regs (T.D. 7882, T.D. 8050, T.D. 8200, T.D. 8774, and T.D. 8879) that have been published since 1982 and that are restated and unchanged. The regs generally are proposed to apply on and after the date the final regs are published in the Federal Register.

The proposed regs define a highway vehicle as any self-propelled vehicle, or any truck trailer or semitrailer, designed to perform a function of transporting a load over public highways. To illustrate the definition of highway vehicle, the regs provide two examples: one on the off-highway vehicle exception and the other on the mobile machinery exception. The regs provide exceptions for specified mobile machinery, off-highway vehicles, non-transportation trailers, and semitrailers for purposes of the tax on the sale of heavy vehicles, the highway use tax, and the credits and payments allowed for some nontaxable uses. The regs also include a change announced in prior guidance (Notice 2005-4, 2005-1 C.B. 28) that current rules regarding some vehicles specially designed for off-highway transportation would not apply to calendar quarters beginning after October 22, 2004.

The proposed regs reorganize and partially restate the temporary regs that address the retail tax on tractors, trailers, and trucks. The proposed regs provide a model certificate for sellers to establish the tax status of incomplete chassis cabs. No tax is imposed on the sale of those cabs when accompanied by a qualifying certificate.

Consistent with the temporary regs, the proposed regs define tractor and truck by reference to the primary design of a vehicle, providing an example and reflecting 2004 guidance (Rev. Rul. 2004-80, 2004-2 C.B. 164). Under the proposed regs, the definition of truck trailer would include any manufactured home on a frame that has axles and wheels, and as a result, a vehicle that tows a manufactured home is taxable as a tractor. The regs provide exclusions from the tax imposed by section 4051 for some trucks and trailers below a specified weight, and modify the temporary regs to reflect the statutory increase in the aggregate dollar value of parts and accessories that may be installed on a taxable article without incurring a tax liability. The regs also supplement the existing definition of taxable sale to include the resale of an unused article that had been previously sold tax free.

The proposed regs provide that if a chassis is a component part of a highway vehicle, its taxability is determined independent of the body installed on the chassis. The same rule applies if a body is a component part of a highway vehicle. The proposed rule is contrary to the result of Rev. Rul. 69-205, which predates and is inconsistent with the language in section 4051(a)(1), and will be rendered obsolete after the final regs are published. The proposed regs reflect changes to the section 4071 tax on tires, define related terms, and address multiple load ratings and the consequences of tampering with a tire’s maximum load rating. The regs also provide rules under section 4073 for making tax-free sales of tires for specified uses.

**Disaster Relief**

The IRS has granted (MS-2016-21) tax relief to victims of severe storms and flooding in parts of Mississippi, postponing until July 15 various tax return filing and tax payment deadlines that occurred starting March 9, including the April 18 deadline for filing 2015 income tax returns and the April 18 and June 15 deadlines for making quarterly estimated tax payments.

A variety of business tax deadlines are also affected, including the May 2 deadline for quarterly payroll and excise tax returns. The IRS is waiving failure-to-deposit penalties for employment and excise tax deposits due on or after March 9, as long as the deposits were made by March 24. President Obama declared that a major disaster exists in Mississippi and that individuals who reside or have businesses in Bolivar, Coahoma, and Washington counties may qualify for tax relief.

Affected taxpayers include individuals who live in the covered disaster area and businesses with principal places of business there; taxpayers that are not in the covered disaster area but have records there that are necessary to meet deadlines; relief workers affiliated with recognized government or philanthropic organizations assisting in the relief activities in the covered disaster area; and any individual visiting the covered disaster area who was injured or killed as a result of the disaster.

**Empowerment Zones**

The IRS has explained (Notice 2016-28, 2016-15 IRB 1) how a state or local government may amend an empowerment zone nomination to provide for a new termination date of December 31.

Under section 1391, a state or local government entity may nominate areas in its jurisdiction for
designation as an empowerment zone. The designations of all empowerment zones now have a termination date of December 31, 2014. The Protecting Americans From Tax Hikes Act of 2015 (PATH Act) extended by two years the period for which an empowerment zone designation is in effect. Thus, section 1391(d)(1), as amended by the act, provides that any designation of an empowerment zone ends on the earliest of (a) December 31, 2016, (b) the termination date designated by the state or local governments in its nomination, or (c) the date a designation is revoked.

Under the PATH Act, an entity must amend its nomination to provide for a new termination date of December 31, 2016, to retain an empowerment zone designation that is effective through that date. Notice 2016-28 provides those procedures. The guidance further provides that any nomination for an empowerment zone with a current termination date of December 31, 2014, is deemed to be amended to provide for a new termination date of December 31, 2016, unless the nominating entity sends written notification to the IRS by May 24. The written notification must affirmatively decline the extension of the empowerment zone nomination.

**Retirement Plan Distributions**

The IRS has reminded (IR-2016-48) taxpayers who turned 70½ during 2015 that in most cases they must start receiving required minimum distributions (RMDs) from IRAs and workplace retirement plans by April 1.

The April 1 deadline applies to the required distribution for only the first year. For all subsequent years, the RMD must be made by December 31. For example, an individual who turned 70½ in 2015 and receives the first required payment on April 1, 2016, must still receive the second RMD by December 31, 2016. The April 1 deadline applies to owners of traditional IRAs but not owners of Roth IRAs.

Although the deadline is mandatory for all owners of traditional IRAs and most participants in workplace retirement plans, some individuals with workplace plans can wait longer to receive their RMD. For example, employees who are still working can, if their plan allows, wait until April 1 of the year after they retire to start receiving the distributions.

Julie Brienza and Emily Vanderweide contributed to this column.
How could an organization be so passionate about tax?

It starts at the top.

“It's understandable if you don’t think the subject is sexy. But my guess is that if anyone other than the government was taking money from you, you'd want to know what they were up to.”

--Chris Bergin
President & Publisher
Only in the pages of Tax Analysts
Eleventh Circuit Affirms Enforcement of IRS Summons

By Joseph DiSciullo — joseph.disciullo@taxanalysts.org

The Eleventh Circuit, in a case remanded by the Supreme Court, affirmed a district court decision that enforced IRS summonses and denied an evidentiary hearing regarding whether the summonses were issued for an improper purpose. The district court held that the IRS made a prima facie showing to enforce IRS summonses and denied an evidentiary hearing regarding whether the summonses were issued for an improper purpose (United States v. Clarke, Nos. 15-11663, 15-11996 (11th Cir. 2016)).

The disputes in the case arise from an IRS examination of the tax returns of a limited partnership for the years 2005 through 2007. Over the course of the investigation, the partnership agreed twice to one-year extensions of the three-year statute of limitations for the IRS to conduct its examination. In 2010 the partnership refused a third extension. Later that year, the IRS issued five administrative summonses to four individuals associated with the limited partnership, none of whom complied. The IRS did not seek enforcement of the summonses from the district court before the limitations period expired and instead issued a final partnership administrative adjustment proposing various adjustments to the partnership’s returns. The limited partnership filed a timely challenge to the FPAA in Tax Court, but those proceedings were stayed in light of the dispute developing in the district court.

In April 2011 the IRS filed five petitions in district court to enforce the previously issued 2010 summonses, submitting an affidavit stating that it followed all administrative steps of the tax code, required the information sought in the summonses to further the investigation, did not already possess the information, and did not issue the summonses for an improper purpose. The district court found that the IRS made a prima facie showing to enforce the summonses and that the appellants responded by requesting a hearing to determine whether the summonses were issued for the improper purpose of retaliating for the partnership’s refusal to extend the limitations period or to circumvent Tax Court discovery limitations. The district court denied the request for a hearing and enforced the summonses, finding that the appellants failed to make any meaningful allegation that the IRS issued the summonses for an improper purpose.

On appeal, the circuit court concluded that the district court abused its discretion by denying the request for an evidentiary hearing because under Eleventh Circuit precedent an allegation of improper purpose in issuing a summons was sufficient to require a hearing. The IRS appealed to the U.S. Supreme Court (134 S.Ct. 2361 (2014)), which granted certiorari, noting that the Eleventh Circuit was alone in asserting that a “bare allegation of improper motive entitles a person objecting to an IRS summons to examine the responsible officials.” The Supreme Court rejected that view and provided the clear standard that a “taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith.” The Court remanded to the Eleventh Circuit, which in turn remanded to the district court with instructions to use the new standard. Ultimately, the district court found that none of the grounds on which the appellants challenged the IRS summonses were improper as a matter of law.

The circuit court noted that the IRS’s authority to investigate is extensive but that its summons authority is subject to limitations. The court disagreed with the district court opinion that none of the alleged purposes for issuing the summons were improper as a matter of law. The circuit court said that an IRS summons only to retaliate against a taxpayer would be improper as a matter of law because it would be “akin to improper harassment of the taxpayer.” Moreover, the court decided that issuing a summons in bad faith for the sole purpose of circumventing Tax Court discovery would be an improper purpose as a matter of law but found that the circumstances under which a taxpayer could successfully make this challenge “are exceptionally narrow.”

Although the Eleventh Circuit held that the district court erred in finding the allegations set forth by the appellants could not constitute an improper purpose as a matter of law, the circuit court held that the appellants failed to meet their burden under the standard established by the Supreme Court. The court concluded that the appellants failed to show facts giving rise to a plausible inference of improper motive because they relied on conjecture and bare assertions. Moreover, the district court’s decision not to hold a status conference or permit additional evidence was appropriate in light of the summary nature of a summons enforcement proceeding, the court said.
Foreign Tax Credit

A district court held that the estate of a U.S. citizen who lived and worked in the Philippines for seven years is entitled to a $1.2 million tax refund, finding that the IRS’s substitute returns for that period failed to take into account foreign taxes paid from his overseas work and failed to apply the foreign earned income exclusion (Estate of Herrick v. United States, No. 2:12-cv-00671 (D. Utah 2016)).

The estate sought a tax refund from the IRS for the calendar years 2000 through 2006, during which time the decedent lived and worked in the Philippines but mistakenly believed that he would not owe any U.S. taxes on the income he earned in that country because of the high rate of tax he paid there. When the decedent failed to file U.S. income tax returns, the IRS prepared substitute returns for the years in question but did not account for the foreign taxes he paid. The IRS determined that the decedent owed $1,330,162.66 in U.S. taxes and levied that amount from his American investment accounts to pay the assessed liabilities.

The decedent’s daughter, who was the administrator of the estate, learned of the tax issues and had U.S. income tax returns prepared and filed for tax years 2000 through 2006. Unlike the returns prepared by the IRS, these tax returns took into account the decedent’s foreign taxes paid and applied the foreign earned income exclusion. The parties agreed that the estate satisfied the three jurisdictional requirements for seeking a tax refund: (1) full payment of the tax assessed; (2) timely filing of a refund claim with the IRS; and (3) compliance with the statute of limitations for filing a refund suit. They could not reach agreement, however, on whether the estate was entitled to the foreign tax credit and the foreign earned income exclusion.

The estate provided the IRS with copies of the decedent’s tax returns that he submitted to the Philippines Bureau of Internal Revenue (BIR). The estate also obtained the decedent’s employment records relating to tax filings from 2000 through 2006 and a certification from the BIR regarding the taxes paid from 2001 through 2006. The BIR did not provide a certification for the year 2000 because neither the BIR nor the decedent’s employer could locate the specific form showing the transmittal of the tax payment. Accordingly, the IRS argued that the tax returns from the decedent’s records and his employer’s records were insufficient for the year 2000 and that the information for the years 2001 through 2006 did not demonstrate whether subsequent adjustments were made that could have resulted in a reduced amount of those liabilities.

The district court found no evidence that the amount of taxes on the year 2000 returns was incorrect or that adjustments were later made to the taxes paid for 2001 through 2006, which were certified by the Philippines BIR. The court said the IRS was merely speculating that there might be additional information and that to defend against a motion for summary judgment, the Federal Rules of Civil Procedure require more than speculation that additional facts could be found. Therefore, the court concluded that the estate was entitled to the FTC.

The IRS contended that the estate was not entitled to the foreign earned income exclusion under section 911 because that exclusion is available only if a taxpayer makes an election on a timely filed income tax return or an amendment to a timely filed return, or files within one year after the due date of the return. The court also rejected that claim, pointing out that the regulations under section 911 allow a taxpayer to make the foreign earned income exclusion after the prescribed time periods have expired in specified situations. Specifically, section 911 applies if there is still some tax liability owing but the IRS has not yet discovered that the taxpayer failed to elect the exclusion. Accordingly, the court concluded that the estate made a timely section 911 election of the foreign earned income exclusion that can be applied to the decedent’s tax returns for 2000 through 2006. Summary judgment for the estate was therefore granted.

Return Information Disclosure

A U.S. bankruptcy court denied a debtor’s motion to prohibit testimony by IRS witnesses and to strike IRS exhibits as a violation of section 6103 in a hearing on the conversion or dismissal of their bankruptcy case, finding that the return information at issue was related to the resolution of the case and could be disclosed and used in the hearing (In re Wendell Lawrence Jr., No. 14-00950 (Bankr. D. Idaho)).

Although several bankruptcy plans have been proposed, none progressed to consideration of confirmation because the debtor failed to obtain the prerequisite approval of a disclosure statement. The U.S. trustee and the IRS moved to convert or dismiss the case, and a secured creditor filed two separate motions for stay relief. Consistent with the bankruptcy court’s requirements for prehearing evidentiary disclosures, the IRS disclosed its prospective witnesses and exhibits.

The debtor sought to prohibit the testimony of the proposed witnesses — an IRS revenue officer and an IRS revenue agent — and to strike all of the IRS’s proposed exhibits except its filed proof of claim. The debtor argued that the testimony or documentary evidence is prohibited by section 6103(h)(4), at least in the context of the hearing on conversion or dismissal.
The IRS responded that the evidence is proper in connection with its arguments for conversion or dismissal, including the debtor’s failure to pay post-petition taxes, unreasonable delay, and the absence of a reasonable likelihood of rehabilitation. Under section 6103(h)(4), “a return or return information” may be disclosed in a federal or state judicial or administrative proceeding pertaining to tax administration if: (1) the taxpayer is a party to the proceeding, or the proceeding arose out of or in connection with the taxpayer’s civil or criminal liability or the collection of that liability; or (2) the treatment of an item reflected on the return is directly related to the resolution of an issue in the proceeding.

The bankruptcy court agreed, noting that a bankruptcy case in which a taxpayer is a party can implicate the enforcement of tax law in several ways. According to the court, a debtor files for bankruptcy with the intent that all of the debtor’s assets and liabilities, including tax liability, will be determined and accounted for in a payment plan. The intent to adjudicate tax liability is inherent in the bankruptcy filing, regardless of the final outcome, the court explained.

The bankruptcy court rejected the debtor’s claim that the word “proceeding” in section 6103(h)(4) encompasses the IRS’s filing of a proof of claim but not the IRS’s motion to convert or dismiss, which the debtor said had nothing to do with the determination of its own tax liability. “Such a construction is inappropriately and unreasonably narrow,” the court said, adding that there is no dispute that section 6103(h)(4)(A) authorizes the disclosure of return information in judicial proceedings involving a taxpayer’s civil or criminal liability.

The fact that the IRS’s assertions and its proposed supporting documentary and testimonial evidence regarding the debtor’s tax liability might be more directly addressed through claim objection does not make the evidence irrelevant to the issues raised under the motion seeking dismissal or conversion, the court said. According to the bankruptcy court, the debtor’s “attempt to cabin the evidence and allow it only in later claim-specific litigation” advanced by the debtor “but foreclose its use in connection with the matters brought by creditors . . . is unpersuasive and untenable.”

**Prohibited Transactions**

The Tax Court held that a couple participated in prohibited transactions in 2003 by personally guaranteeing loans to a company owned by their IRAs in their acquisition of a metal fabrication business, leaving them liable for tax on deemed distributions from the accounts and a 10 percent early distribution penalty (Thiessen v. Commissioner, 146 T.C. No. 7 (2016)). (Related coverage: p. 25.)

As part of the couple’s decision to buy the assets of a metal fabrication business, they rolled over their tax-deferred retirement funds into newly formed IRAs, which acquired the initial stock of a newly formed company. The new company acquired the assets of the business they had set out to buy. The couple guaranteed the repayment of a loan that the company received from the seller as part of the acquisition price.

The couple reported on their 2003 income tax return a nontaxable rollover of retirement funds into IRAs but failed to indicate that they had guaranteed the loan and made no mention of the new company or its 2003 corporate return. In 2010 the IRS determined that the couple was liable for a $180,129 deficiency attributable primarily to unreported IRA distributions. The IRS asserted that the couple’s guaranties were prohibited transactions under section 4975(c)(1)(B) that resulted in deemed distributions of their IRA assets.

The IRA funding structure the couple used was similar to that described in Peek v. Commissioner, 140 T.C. 216 (2013), and, in fact, was implemented by the same CPA and brokerage firm that were involved in the Peek case. The Tax Court agreed with the IRS’s primary argument in both cases — that prohibited transactions occurred when the petitioners guaranteed the loan. The court, rebuffing the couple’s attempts to distinguish their case from Peek, explained that the guaranties were the couple’s indirect extensions of credit to their IRAs and that their participation in the prohibited transactions caused the IRAs to lose their status as IRAs and be deemed to have distributed their assets to the couple in a taxable transaction. The court further held that the couple was liable for the 10 percent additional tax under section 72(t)(1) because neither petitioner was at least 59½ years old during 2003.

The court concluded its decision with an examination of the three-year statute of limitations on assessments under section 6501(a), finding that section 6501(e)(1) extends that period to six years because of the couple’s failure to report gross income in excess of 25 percent of the amount of gross income reported on their return.

*Linda Friedman and Patrice Gay contributed to this column.*
Where
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“The question is not whether states will raise the necessary money. Rather, it’s which groups they will tax.”

— David Brunori,
Deputy Publisher
Only in the publications of Tax Analysts
Commentators Seek Clarification Of Proposed CbC Reporting Regs

By Joseph DiSciullo — joseph.disciullo@taxanalysts.org

The American Bar Association Section of Taxation is among the organizations that have submitted comments on proposed regulations (REG-109822-15) on country-by-country (CbC) reporting for multinational enterprise parent entities, advising against a delayed U.S. effective date and encouraging the IRS to continue to let taxpayers exercise reasonable discretion in completing the report.

Section members applaud many aspects of the proposed regs but warn that the U.S. effective date delay would cause hardships for U.S. companies because they would be required to submit CbC reports directly to foreign tax authorities for fiscal 2016, which in turn would result in multiple filings and potentially weaker data confidentiality protections. Members also describe problems that may arise when a U.S. MNE has foreign constituent entities with annual accounting periods that differ from the U.S. parent’s tax year. If the proposed regs are finalized in mid-2016 as contemplated, section members say, a calendar year-end U.S. MNE may have no filing obligation for its tax year beginning January 1, 2017, if any one of its foreign constituent entities has a 2016 annual accounting period that begins before the publication date of the final regs and carries over into 2017.

Regarding the time and manner of filing CbC reports, members note that the proposed regs provide for the reports to be filed with the U.S. MNE parent’s income tax return — a deadline that is earlier than that recommended by the OECD and would mean the reports could be filed within 12 months after the end of the accounting period to which they relate. Members ask the IRS to reconsider the accelerated deadline because it may impose a significant burden on U.S. MNEs and undermine the flexibility afforded to them elsewhere in the proposed regs to choose the source of the data used to generate their CbC reports. The tax section also would like the final regs to confirm that a taxpayer may use local tax reporting data for jurisdictions where the data are available, while using other approved sources of data for jurisdictions where local tax reporting data are not available.

Section members express concern about tie-breaker rules for residency determinations when a party may be subject to CbC reporting in more than one jurisdiction, noting that the “effective place of management” test under the OECD model is sometimes uncertain. The tax section suggests that when residency is being used to define information reporting obligations and not to determine substantive rights under an income tax convention, the IRS should consider an alternative, bright-line tie-breaker rule.

The tax section asks the IRS to clarify the meaning of the term “tax jurisdiction of residence” in prop. reg. section 1.6038-4(b)(6) as it applies to territorial tax regimes, and also to clarify the treatment of subpart F income and similar items to prevent potentially misleading double counting. Lastly, section members request additional guidance on the operation of partnerships and partnership attributes to ensure that reporting is consistent across countries.

In a separate letter, the American Institute of CPAs has recommended allowing U.S. MNE groups to elect on a voluntary basis to apply the proposed regs for tax years beginning on or after January 1, and before the effective date of the final regulations.

The institute requests clarification that a U.S. MNE group’s reporting is based solely on its own annual accounting period and is not contingent on the timing of the annual accounting periods of its foreign constituent entities. The AICPA would also like the IRS to clarify the classification of specified assets as tangible, intangible, or cash equivalents, as well as issues related to the reporting of the number of full-time equivalent employees for each tax jurisdiction.

The institute asks for confirmation of the status of U.S. possessions and territories and whether their treatment as foreign jurisdictions is correct. Lastly, the AICPA suggests a national security exception for information contained in the CbC reports.

The Tax Executives Institute has urged the IRS to adopt a filing deadline consistent with the OECD standard — one year after the end of the relevant tax year — even if it necessitates a separate filing with the IRS. The institute believes this would preserve the flexibility provided to taxpayers by the regulations when choosing the data to populate the CbC reports.

TEI recommends that the final regs be consistent with the OECD standard prescribed in the final
action 13 report for purposes of determining the location of an employee. The institute thinks the regs should let taxpayers report their employees based on the tax residence of their employer. TEI also proposes that taxpayers be allowed to report an employee as a “full-time equivalent” based on their usual practice as long as the company does so consistently from year to year and across entities, and as long as the method does not materially distort the relative distribution of employees across the various tax jurisdictions.

TEI suggests that CbC reports not be included in information shared by the IRS with state and local jurisdictions in the United States and that public guidance include a statement to that effect. The institute also asks the IRS to publish a list of countries with which it is exchanging the reports, on its website or elsewhere, to enable taxpayers to properly anticipate and react to direct requests for the CbC report data.

Other coalition recommendations include requiring CbC reports to be publicly available, treating CbC reports as Treasury reports rather than tax return information, mandating the issuance of an annual public summary containing aggregated information from the CbC reports, and sharing CbC information through the multilateral exchange agreement created for that purpose instead of through the U.S. network of bilateral tax agreements.

**Dividend Equivalents**

The New York State Bar Association Tax Section has submitted a report on final, temporary, and proposed regulations (T.D. 9734, REG-127895-14) under section 871(m) on the use of derivatives to avoid withholding tax on U.S.-source dividends.

Regarding the final regs, the tax section recommends clarifying when delta should be tested and explaining how issuers can ensure that allotment options have the same section 871(m) status as the original issuance. Section members
also suggest modifying the safe harbor for indices with a relatively modest U.S. component.

The tax section believes the final regs strike a reasonable balance by ordinarily basing the dividend equivalent on the actual dividend but allowing taxpayers to elect to use an estimate as long as this choice is made in advance. Section members think it is important, however, for the IRS and Treasury to enforce the requirement that estimates have to be reasonable.

Referring to the provision in the final regs under which section 871(m) withholding is not required when section 305(c) already imposes withholding, the report recommends that similar relief be offered when a section 871(m) transaction is subject to withholding for a reason other than section 305(c), such as when a periodic payment is treated as fixed, determinable, annual, or periodical income. Regarding the provision in the final regs that generally defers withholding until a payment is made, the tax section requests confirmation that the provision is intended to delay the foreign holder’s tax liability and not just the obligation to withhold.

The report suggests that the final regs need clarification regarding which party is responsible for determining whether equity-linked notes are section 871(m) transactions and for withholding on these instruments. The tax section says further guidance is also needed on what information the responsible party has to provide.

Regarding the temporary regs, section members recommend clarifying that the test for simple contracts should be used whenever transactions offer economic exposure to an ascertainable number of shares, including instruments that include an automatic adjustment for mergers and stock splits, instruments that are “net share settled,” and put and call spreads. For purposes of comparing complex contracts with “closely comparable” simple contracts under the temporary regs, the tax section suggests adding guidance on the criteria for determining that a simple contract is closely comparable.

Deemed Asset Sale Elections

The District of Columbia Bar Taxation Section has recommended changes to the final deemed asset sale election regulations (T.D. 9619), asking the IRS to mitigate the issues arising from creeping qualified stock dispositions (QSDs) by requiring that a section 336(e) election may be made only for those dispositions in which a purchaser acquires “stock meeting the requirements of section 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders” in a QSD.

The tax section asks the IRS and Treasury to accommodate flexibility in the scope of property included in a target’s plan of liquidation by providing a rule that, unless a formal plan of liquidation that contemplates the section 336(e) election is adopted on an earlier date, the making of the election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in reg. section 1.336-2(b)(1)(iii).

Section members suggest limiting the application of the step transaction doctrine (or similar rule of law) and clarifying the circumstances in which the installment sale provisions might apply to gain realized by a target in a deemed asset disposition under reg. section 1.336-2(b)(2)(i). The tax section would also like the IRS and Treasury to confirm the role that target stock redemptions play in effecting a QSD and the ability to make a section 336(e) election when the seller completely liquidates under section 336 by distributing an amount of target stock that would constitute a QSD.

The tax section recommends adding section 1239 to the list of related party exceptions under reg. section 1.336-2(b)(2)(ii)(C). Lastly, section members request clarification of the substantive requirements necessary to make a valid section 336(e) election.

Withholding

Baker & McKenzie has asserted that any regulations under section 897(l)(3) should confirm that an investment in U.S. real property interests through tiers of wholly owned entities does not disqualify an eligible qualified foreign pension fund (QFPF) from the benefits of the withholding exemption under the Protecting Americans From Tax Hikes Act of 2015 (PATH Act).

The PATH Act generally provides QFPFs an exemption from income and withholding tax imposed under the 1980 Foreign Investment in Real Property Tax Act on the disposition of U.S. real property interests within the meaning of section 897(c). The act authorizes Treasury to issue necessary or appropriate regulations.

Baker & McKenzie recommends that as a matter of proper statutory interpretation, legislative intent, and sound tax policy, any future regulations should confirm that a QFPF holding a U.S. real property interest indirectly through one or more tiers of wholly owned entities remains entitled to the FIRPTA exemption provided in the PATH Act.

The firm says the regs should confirm that a QFPF investing in U.S. real property interests along with other QFPFs through an aggregate investment vehicle that is owned solely by multiple QFPFs remains entitled to the FIRPTA exemption provided in the PATH Act.

Lastly, the firm requests confirmation that a QFPF owning an interest in a real estate investment trust indirectly through a tax-transparent entity...
(such as a partnership) remains entitled to the FIRPTA exemption in the PATH Act for distributions attributable to the REIT’s disposition of a U.S. real property interest.

Julie Brienza, Eben Halberstam, Andy Sheets, and Emily Vanderweide contributed to this column.
Is There a Presumption Against Extraterritorial Taxes?

By Jasper L. Cummings, Jr.

I. The IRS Backs Down

A. An Insurance Excise Tax Case

Just over a year ago, the D.C. Circuit held against the IRS in *Validus*,
1 a foreign insurance excise tax case. That might not seem like news except for one thing: The IRS has since issued Rev. Rul. 2016-3, 2016-3 IRB 282, which revokes Rev. Rul. 2008-15, 2008-1 C.B. 633, and effectively acquiesces in the *Validus* holding. The IRS gave up on collecting the foreign insurance company excise tax from what must be a lot of Bermudan insurance companies.

The D.C. Circuit did not interpret the foreign insurance excise tax sections but rather applied a presumption against extraterritoriality of a U.S. statute. It did so by defining extraterritorial uniquely. As far as I could find, this is the first time in the history of U.S. taxation that an excise tax has been interpreted not to apply to a foreign transaction solely on the basis of a presumption against extraterritoriality. And *Validus* is one of only three cases in which a U.S. tax has been interpreted not to apply to a foreign subject, even in part, on that basis.2 The court seemed not to comprehend the singularity of its decision.

The D.C. Circuit created a new excise tax regime that converts what looks like a two-or-more-excise-taxes regime into a one-excise-tax regime. For a single U.S. risk, the D.C. Circuit will allow only one foreign insurance company to be taxed — either the one that issued the policy or one of the reinsurers. The result is to negate the most likely reason Congress chose to tax primary foreign insurers at 4 percent of the premium and reinsurers at only


2As discussed below, the Supreme Court in *United States v. Gaetet*, 232 U.S. 293 (1914), held that an excise tax on foreign-built and -used yachts was not intended to apply to an owner who was a nonresident citizen, but it relied on other statutory indicators. In *Holsten v. Commissioner*, 35 B.T.A. 568 (1937), aff’d, 93 F.2d 1002 (2d Cir. 1937), the Board of Tax Appeals held that a foreigner’s stocks and bonds issued by U.S. corporations were not subject to the estate tax if their situs by physical presence was not in the United States. This decision was based more on the historical importance of situs than on the presumption against extraterritoriality. See infra discussion of the withholding tax on royalties.
one-fourth that rate (1 percent of the premium): because the taxes might apply in tandem.3

The D.C. Circuit applied the foreign insurance excise tax this way:

- Case 1: X, a U.S. insurer, writes insurance on U.S. risks and buys reinsurance from foreign insurer Y, which buys reinsurance from foreign insurer Z. Assume that Y is doing business in the United States but Z is not. The premium that Y pays to Z in a foreign-to-foreign transaction is subject to the 1 percent excise tax on premiums paid to foreign reinsurers because Y is not doing business in the United States. The premium paid by X to Y is exempt under the terms of the statute because it is taxable to Y as effectively connected income.
- Case 2: Same facts as Case 1, but Y is not doing business in the United States. The foreign-to-foreign premium that Y pays to Z is not subject to the 1 percent excise tax on premiums paid to foreign reinsurers because Y is not doing business in the United States, but the premium that X pays to Y is subject to that tax. This is the Validus scenario.
- Case 3: Same facts as Case 2, but there is no insurer X, and Y sells the primary insurance on a U.S. risk. The premium paid to Y is subject to the 4 percent tax on premiums paid to foreign insurers, but the foreign-to-foreign premium Y pays to Z is not subject to the 1 percent tax under the reasoning of the D.C. Circuit’s opinion (because Y is not doing business in the United States). Rev. Rul. 2016-3 agreed to Case 3 (Situation 1 of Rev. Rul. 2008-15), as well as Case 2.

Using the words of the D.C. Circuit, Validus Reinsurance Ltd. and similar foreign reinsurers will not be subject to the excise tax on the foreign-to-foreign reinsurance premiums they pay because the transaction is “wholly foreign.” That term was lifted from the plaintiff’s brief because foreign corporation Validus was not doing business in the United States. If this seems confusing enough to be interesting, read on. There may be some refunds to be claimed.

2. What were they thinking? In issuing Rev. Rul. 2016-3, the IRS and Treasury must have been thinking that (1) if the solicitor general would not petition for certiorari in Validus (and he makes that call), the IRS Office of Chief Counsel does not have the horsepower to defend the government’s rejected position; and (2) continuing to set up assessments against foreign insurers of this type would be futile because, like Validus, they would pay the tax and sue for a refund in the U.S. District Court for the District of Columbia (the refund venue for foreign insurance companies that don’t have a U.S. office and don’t file), which would be bound by the Validus decision as circuit precedent.

The solicitor general likely did not want to petition for certiorari because although the decision involves a minor tax, the opinion’s reasoning implicates a huge political-legal issue that the Republican-appointed justices on the Supreme Court (a majority at the time) would almost certainly decide against the Obama administration (discussed below).

Commentators seem to think the D.C. Circuit got it right.5 This report presents the contrary view. Probably few readers practice insurance excise tax law, but Validus is worth knowing about for these reasons:

- The plaintiff can be viewed as a foreign tax haven corporation organized by U.S. hedge or private equity funds, which implicates many tax planning features of wide appeal.
- The recent revenue ruling shows how one appellate defeat can stymie Treasury. This is great for taxpayers but raises the huge issue of how the government responds to one-off adverse court holdings (it does not respond well — a subject for another day).
- The case suggests a practical explanation of why the government sometimes takes wildly aggressive positions against foreign non-taxpayers (say a Bermudan insurer): If it is

3In the 1939 code, primary insurance was taxed at 3 percent, and reinsurance was exempt. The Revenue Act of 1942 changed that to 4 percent and 1 percent, respectively.

428 U.S.C. section 1402(a)(2). The statute actually sets up an interesting choice for some foreign non-taxpayers. In some cases, foreign corporations that do not think they owe U.S. tax file protective returns to claim deductions. Protective income tax returns must be filed in the Utah IRS office. If the IRS assesses income tax and the foreign corporation pays, a suit for refund will have to be filed in Utah, in the Tenth Circuit, rather than in the District of Columbia, the venue for foreign persons with no U.S. office and no return filings.

going to lose cases in the international area that it ought to win (arguably this one), it may as well take more shots at the basket.

• The D.C. Circuit’s opinion purported to apply yet another limit on *Chevron* deference, similar to that applied in the Tax Court’s *Altera* holding.\(^6\)

• Most important, the circuit’s opinion promoted to the status of a positive rule of law an interpretive presumption that Congress does not intend extraterritorial application of U.S. statutes. This was the first time that has been done in a federal tax case. That promotion is a Republican idea that generally serves business interests wanting to limit the reach of U.S. business regulations — and now taxes. After *Validus*, we may see this rule asserted more often in tax cases, including those involving the important *Quill* issue (although the context is different).\(^7\)

### B. Another Big Legal Deal Some of Us Missed

#### 1. The presumption.

Like *Chevron* deference,\(^8\) but slightly less famous in the nontax legal world, is the retooled presumption against extraterritorial application of U.S. statutes. Tax lawyers — at least the older ones — are likely oblivious to this hot academic topic, given its general irrelevance to the income tax. Also, many tax lawyers became aware of *Chevron* only recently, when the Supreme Court finally applied it in a tax case: *Mayo*.\(^9\) But now the D.C. Circuit has applied the presumption against extraterritoriality in a tax case, albeit an excise tax case.

*Chevron* deference and the presumption have similar features. Both doctrines purport to reduce courts’ ability to use traditional judicial tools to interpret statutes. They replace those tools with deference to agency interpretations and with a presumption, respectively. And yet some Supreme Court justices seem to have realized that both doctrines tend to strip judges of the power to do what judges do. Consequently, the Republican-appointed justices in particular have pulled back from *Chevron*.\(^10\) And there is some evidence in *Morrison*,\(^11\) the Supreme Court’s most recent opinion on the presumption against extraterritoriality, that Justice Antonin Scalia was pulling back from the presumption. In that case, he introduced a new way for judges to trump the presumption — by finding that the “focus” of the transaction is mostly domestic.\(^12\)

The *Chevron*-like nature of the presumption issue is also shown by the fact that Shepard’s Citation Service lists more than 2,000 citations to the 2010 *Morrison* opinion. The *Chevron* citations similarly are large and are too many for Shepard’s to post (more than 20,000), but *Chevron* had a 26-year head start. *Validus* shows what can happen when nontax doctrines are parachuted into tax disputes. The general jurisdiction court judges know more about those doctrines than they know about tax law, and they can tend to be overly influenced by them.

#### 2. By another name.

The tax community got an early warning of the presumption against extraterritoriality in 1996, when the Tax Court held in *SDI Netherlands*\(^13\) that the IRS could not impose what the court called a “cascading” withholding tax on foreign royalties. The Tax Court gave no evidence of knowing about the presumption, but as an additional observation, it stated that it did not believe that Congress intended the cascading tax.

In *SDI Netherlands*, royalties were paid from the United States to a Netherlands corporation, and no taxes were withheld because of an exemption under the Netherlands tax treaty. Then the Netherlands corporation paid almost the same royalty to a Bermuda corporation for the U.S. use of the patent. The IRS tried to impose withholding tax on the Netherlands-to-Bermuda royalty, but the court disallowed it.

An insightful article on the decision speculated that the anti-cascading idea might be applied to the foreign insurance excise tax, and it cited TAM...
noted the potential connection between the two taxes. See Tariff Act of August 5, 1909, even though the conduct could not abuse — to override treaty exemptions.

The article was proved right.

C. The Anti-Regulation Agenda
1. Holmes’s interpretive tool. For any who still don’t believe that factions on the Supreme Court have agendas that have been pursued over decades — aided by presidents who appoint like-minded successors to fill vacant seats — consider the presumption against extraterritoriality. It began simply enough as an aid to statutory interpretation in Justice Oliver Wendell Holmes Jr.’s American Banana opinion. Holmes reasoned that when there is doubt about a statute’s territorial scope, it should be interpreted to apply to the territory over which the legislature has jurisdiction. The idea was rooted in the conflict-of-law views of his contemporary, Harvard Law School professor Joseph Henry Beale, and was based on a now-archaic belief that the sovereignty of nations is limited to their geographical footprints.

The Sherman Antitrust Act was the statute at issue in American Banana, decided in 1909. One U.S. banana company had induced Panama and Costa Rica to seize the property of the other U.S. banana company. The Court refused to award treble damages under the Sherman act. It found it improbable that Congress would have tried to criminalize that conduct in a foreign country, so treble damages should not be allowed as the alternate civil penalty. The opinion weighed only two considerations: (1) that the statute used general terms and did not refer to foreign acts one way or the other; and (2) the law of nations that each sovereign holds the power to make particular conduct legal or illegal within its borders (monopolization was not illegal in Panama).

Within four years, the Court backpedaled in a tax case, and Holmes joined the opinion. And in 1962 the Court said that American Banana had been negated by other contrary holdings. More generally, the presumption against extraterritoriality fragmented over the years.

2. The modern era. In 1991 when William H. Rehnquist as chief justice revived and retooled the presumption in Aramco, he didn’t even cite American Banana. The Court in Aramco dismissed an Equal Employment Opportunity Commission complaint against a U.S. corporation for firing a U.S. citizen in Saudi Arabia because of his race and religion. The holding relied in part on a presumption against extraterritoriality. The Court created the procedural theory (picked up by the D.C. Circuit) that two plausible interpretations of a statute should be resolved by application of the presumption. Justices Thurgood Marshall, Harry A. Blackmun, and John Paul Stevens dissented, protesting Rehnquist’s inaccurate rewrite of the evolution of the Holmes presumption:

Contrary to what one would conclude from the majority’s analysis, this canon is not a “clear statement” rule, the application of which relieves a court of the duty to give effect to all available indicia of the legislative will. Rather, as our case law applying the presumption against extraterritoriality well illustrates, a court may properly rely on this presumption only after exhausting all of the traditional tools “whereby unexpressed congressional intent may be ascertained.”

Professor Larry Kramer explained that the Aramco dissent identified two different appropriate roles for the presumption: (1) to fill gaps when the intent of Congress cannot otherwise be determined by normal means (a role similar to Chevron deference); and (2) to apply when important issues concerning the president’s control over foreign affairs are at stake. Neither use was implicated in Aramco, according to the dissent. They aren’t implicated in Validus, either.

Then in 2010, Scalia (writing for Chief Justice John G. Roberts Jr. and justices Anthony M. Kennedy, Clarence Thomas, and Samuel A. Alito Jr.) held in Morrison that a recovery under SEC Rule 10b-5 could not be obtained by a foreign securities buyer against foreign and U.S. defendants, relying

be prosecuted as criminal. United States v. Twenty-Five Packages of Panama Hats, 231 U.S. 358 (1913).


Aramco, 499 U.S. at 250.

Id. at 261.

Kramer, supra note 16, at 201.
in part on the presumption against extraterritoriality. This time Stevens, joined by Justice Ruth Bader Ginsburg, dissented, stating:

First, the Court seeks to transform the presumption from a flexible rule of thumb into something more like a clear statement rule. We have been here before. In the case on which the Court primarily relies, EEOC v. Arabian American Oil Co., 499 U.S. 244, 111 S. Ct. 1227, 113 L. Ed. 2d 274 (1991) (Aramco), Chief Justice Rehnquist’s majority opinion included a sentence that appeared to make the same move.

Yet even Aramco — surely the most extreme application of the presumption against extraterritoriality in my time on the Court — contained numerous passages suggesting that the presumption may be overcome without a clear directive. See id., at 248-255, 111 S. Ct. 1227, 113 L. Ed. 2d 274 (majority opinion) (repeatedly identifying congressional “intent” as the touchstone of the presumption). And our cases both before and after Aramco make perfectly clear that the Court continues to give effect to “all available evidence about the meaning” of a provision when considering its extraterritorial application, lest we defy Congress’ will. . . .Contrary to Justice Scalia’s personal view of statutory interpretation, that evidence legitimately encompasses more than the enacted text. Hence, while the Court’s dictum that “[w]hen a statute gives no clear indication of an extraterritorial application, it has none” . . . makes for a nice catchphrase, the point is overstated. The presumption against extraterritoriality can be useful as a theory of congressional purpose, a tool for managing international conflict, a background norm, a tiebreaker. It does not relieve courts of their duty to give statutes the most faithful reading possible.

And then in 2015, the D.C. Circuit stated the following in Validus:

The Supreme Court has instructed that a court must presume that a statute has no extraterritorial application “unless there is the affirmative intention of the Congress clearly expressed’ to give a statute extraterritorial effect” [citing Morrison, which cited Aramco].

Yet in Morrison even Scalia denied he was applying a clear statement rule. All three judges on the D.C. Circuit panel were originally appointed to the federal bench by Republican presidents, although the opinion’s author was elevated to the circuit by President Clinton. You can say that the D.C. Circuit was just following the Supreme Court. But it would be more accurate to say that it was following the strictest version of the Republican-appointed Supreme Court (then) majority’s view of an interpretive presumption. And you also should understand that this presumption has been turned into an ideological, if not political, tool rather than an interpretive legal tool as Holmes originally conceived it.

II. Facts of Validus

Validus was a foreign reinsurance company that reinsured policies issued by other insurers in the United States. Validus itself bought reinsurance from foreign companies, which is called retrocession in the insurance industry but is here called re-reinsurance. Although the court and the parties assumed that re-reinsurance (cases 1 and 2, above) is an unremarkable event, it is important to understand that it was also an unremarkable event in 1942, when the excise tax was amended to approximately its current form. Also, reinsurances were then commonly bought across national borders as it is today, although World War II upset the business of many of the European reinsurers.

Validus was organized as a Bermudan corporation in 2006 and engaged in a U.S. public offering of stock at original issue plus some shares held by the original shareholders, private equity funds, or other investment bankers. Validus reinsured U.S. insurers and received premiums that were not subject to either U.S. or Bermudan income tax; they were not income effectively connected with a U.S. trade or business, and Bermuda did not have a corporate income tax.

The IRS determined in 2012 that Validus owed the section 4371 excise tax on the premiums it paid in 2006 to other foreign reinsurers. Validus paid the

24Id. at 265; see Brilmayer, supra note 7, at 660.
25The taxpayer and the court insisted on calling the second reinsurance retrocession, which may be the usage in some circles, but it tends to cause prejudgment of the outcome of the controversy by making the second reinsurance appear not to meet the statutory term “reinsurance.”
27Available at http://www.sec.gov/Archives/edgar/data/1348259/000095012307010068/e28184a6sv1za.htm.
tax and sued for refund in the U.S. District Court for the District of Columbia, where it won summary judgment. The tax at issue was 1 percent of the gross premium Validus paid on reinsurance it bought.

The district court’s opinion did not spend much time on the facts. It did not even state that a 1 percent excise tax had been paid on the reinsurance premiums that Validus received, although that must have been the case. The district court’s grounds were narrower than the circuit court’s: that reinsurance could refer only to the first reinsurance policy issued by a foreign reinsurer to the original insurer, as discussed below. It did not restrict the excise tax to one application per domestic risk, because it allowed a foreign insurer without ECI to be taxed on its premiums received at 4 percent and its reinsurer to be taxed at 1 percent. Thus, the circuit’s grounds are likely to reduce the yield from the tax more than the district court’s grounds.

III. The Foreign Insurer Excise Tax

If you had not heard the plaintiff’s argument or read the two opinions, you probably could not guess how the taxpayer won. Sections 4371-4374 impose excise taxes solely on premiums paid to foreign insurers, which specifically include foreign reinsurers. The issue in Validus was whether they also include foreign re-reinsurers on the particular facts of the case (that is, when the first reinsurer both has not earned ECI and has not written the primary insurance).

Section 4371(3) imposes the 1 percent tax on the reinsurance premium, and section 4372(f) defines reinsurance. It does so in the broadest possible terms to include the reinsurance of all domestic risks insured by underlying primary insurance contracts. Section 4373(1) exempts premiums that are ECI (unless exempt from income tax under a treaty, which could not apply to a Bermuda reinsurer). The statute assumes (correctly) that foreign issuers can insure U.S. risks without doing business in the United States for income tax purposes. The tax rate is 4 percent on the primary insurance premium paid to a foreign insurer and 1 percent on a reinsurance premium paid to a foreign reinsurer.

Therefore, without even addressing re-reinsurance, section 4371 appears to create the potential for at least two excise taxes totaling 5 percent for the same underlying risk for a single reinsurance, which might be called cascading taxes. The obvious potential for cascading may be why Congress set the rate on the primary policy at 4 percent and on the reinsurance at 1 percent. Neither party in Validus came up with a historical explanation for the difference in rates.

But the appearance is wrong, according to Rev. Rul. 2016-3. The revenue ruling sets out Case 2 above (the Validus scenario) and concludes that the 1 percent reinsurance tax cannot be applied, although the 4 percent tax can. Nothing in the statute precludes multiple excise taxes or their application to foreign reinsurers. Indeed, the whole point of the statute is, and always has been, to tax foreign insurers and reinsurers that are not subject to the income tax. That bears repeating: The whole point of the tax is to have extraterritorial effect — a point that the Justice Department valiantly tried to argue.

So how did Validus win?

IV. Plaintiff Sells the Hot Dog

A. To the Trial Court

The trial court bought the plaintiff’s primary argument that the statute taxes only reinsurance premiums paid by the primary insurer. However, that argument was by no means straightforward. It involved focusing on the word “cover” in section 4371(3) and depended on wholly ignoring an alternate use of the word. One would think that the broader definition of reinsurance in section 4372(f) was sufficiently expansive not to be limited to the original insurer. It describes reinsurance of the underlying risk, however achieved. But the trial court held that the references to “cover” and “contract” in section 4371(3) meant that the reinsured party had to be a party to the primary insurance contract. The trial court in effect read the 1 percent

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28Validus, 19 F. Supp.3d 225.
29Section 4372(f) says: “For purposes of section 4371(3), the term ‘policy of reinsurance’ means any policy or other instrument by whatever name called whereby a contract of reinsurance is made, continued, or renewed against, or with respect to, any of the hazards, risks, losses, or liabilities covered by contracts taxable under paragraph (1) or (2) of section 4371.”
30Section 4371 says:
There is hereby imposed, on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer, a tax at the following rates:
1. Casualty insurance and indemnity bonds. 4 cents on each dollar, or fractional part thereof, of the premium paid on the policy of casualty insurance or the indemnity bond, if issued to or for, or in the name of, an insured as defined in section 4372(d);
2. Life insurance, sickness and accident policies, and annuity contracts. 1 cent on each dollar, or fractional part thereof, of the premium paid on the policy of life, sickness, or accident insurance, or annuity contract; and
3. Reinsurance. 1 cent on each dollar, or fractional part thereof, of the premium paid on the policy of reinsurance covering any of the contracts taxable under paragraph (1) or (2).
tax to apply to “reinsurance covering any of the [primary] contracts” written by the person buying the reinsurance.

That interpretation was doubly wrong, as the D.C. Circuit more or less realized. First, the trial court refused to read the definition of reinsurance as informing the meaning of the taxing clause. That is the standard method of interpretation: The definition is a more specific part of the statute, and the more specific parts govern. Tax folks are always looking for a definition to plug into the operative section and would naturally do so here. However, the circuit court also accepted the novel argument that Congress intended to state a broad definition and then to use only part of it in the taxing section.

Second, the trial court interpreted the statute to require that the primary contract be written by Validus because the reinsurance it purchased had to “cover” the primary contract — something that could occur only if Validus wrote the primary insurance.

That makes no sense. Does it mean that if the statute had not referred to the primary contract, the Justice Department might have won? But how could Congress have defined reinsurance, which might be far removed from the primary policy, without referring to the primary policy? Without the primary policy, there is nothing to reinsure, either the first or the second time. All Congress did in section 4371(3) was to define (by reference to section 4372(f)) the set of primary contracts with which it was concerned, and then to levy a tax on reinsurance “covering,” meaning reinsuring, risks of the insured based on those primary contracts.

Wily tax planners saw the flaw in the trial court’s logic: A Bermudan reinsurer like Validus could avoid all excise taxes (not just the tax on the reinsurance Validus bought) by arranging for some sort of reinsurance to be obtained by the original U.S. insurer, first from a U.S. reinsurer and then from Validus, which then could buy its own reinsurance. That way Validus would never be reinsuring the original insurer and could never be taxed, either by the income tax or the excise tax.

B. To the D.C. Circuit

1. On its own terms. Although the D.C. Circuit’s opinion wandered around, in effect it reasoned as follows:

- The plaintiff’s definition of “covering” is plausible but not unambiguously correct (in reality, the D.C. Circuit rejected the trial court’s analysis).
- The Justice Department’s interpretation likewise is plausible but not unambiguously correct.
- The plaintiff’s interpretation of covering would produce a result contrary to the known and clear purpose of Congress to tax re-reinsurance by foreign reinsurers. Observe this point well: The circuit agreed that re-reinsurance could be taxed, as long as it could not cascade as multiple 1 percent taxes on multiple reinsurance contracts.
- Courts should adopt an interpretation that avoids such an anomalous result (meaning defeating the purpose of Congress to tax re-reinsurance) when other interpretations are available. This is the first correct presumption. The D.C. Circuit could have stopped right there and held for the government, but it did not because the plaintiff had argued the Supreme Court’s Aramco line of decisions. As a result, the opinion proceeded to analyze the second presumption, which it said applied only if there were two plausible interpretations of the statute. The D.C. Circuit said:
- The Validus re-reinsurance was wholly foreign.
- When there are two merely plausible interpretations and one would give extraterritorial effect to a statute, and Congress did not clearly

the form of reinsuring risks within the United States and then retroceding those risks to an offshore reinsurer, observers said.

32 The opinions made much of the Justice Department’s awkward definition of cover by analogy to blankets, which the court rejected. If the Justice Department had simply argued that covering meant reinsuring risks originating in the primary contracts, it would have been better off. This is effectively what reg. section 46.4371-2(c)(2) says.
33 See Davis, “Insurance Sees Interesting Developments,” supra note 5 (“Observers said the decision was well-reasoned, and that the court did a good job of rejecting the lower court’s decision, holding that the section 4371(3) excise tax does not apply to retrocession transactions. The lower-court decision opened up an interesting way around the excise tax, which took .

(Footnote continued in next column.)
The whole basis of the circuit’s reasoning is the extraterritoriality presumption. Therefore, you would think that more care would be taken in determining what it means to be extraterritorial. We know that the historical origins of the presumption related to physical jurisdiction.30 Nevertheless, the circuit drew a line between two very similar types of foreign-to-foreign reinsurances, simply by observing a U.S. federal income tax distinction and adopting, without thought, the term “wholly foreign” from the plaintiff’s brief.

The distinction might have made some policy sense if the circuit had reasoned that (1) the United States has taxing authority over a foreign insurer because it does business in the United States, and so (2) that gives the United States authority to require the foreign insurer to also pay an excise tax on premiums it pays. But the circuit did not explain itself that way, and the decision was not based on legislative power.

Instead, the opinion justified its conclusion in an entirely different way: by reference to hypothetical cascading taxes being imposed if multiple foreign-to-foreign reinsurances were taxed. As a result of the circuit’s reasoning, it is impossible for both the 4 percent tax and the 1 percent tax on reinsurance to be applied for the same risk, or for the 1 percent tax on reinsurance to be applied twice for the same risk.

The circuit never exactly identified the relevance of the cascading tax theory to the presumption against extraterritoriality, and there is none. In reality, the cascading tax theory was a third ground, based on an unstated presumption against cascading taxes that has no basis in the law. As noted, the holding precludes not only more than one 1 percent tax but also the 4 percent plus 1 percent combination, even though that is hardly a cascade. The plaintiff offered no evidence of actual cascading beyond its own facts, which would have amounted to a total of 2 percent tax on reinsurance and none of the horribles the amicus brief described. Amici International Underwriting Association of London Ltd. (IUA) and the London & International Insurance Brokers’ Association (LIIBA) asserted that there could be as many as four reinsurance transactions on which the tax could be levied, but they did not prove that.40

The cascading tax problem is discussed further below.

Footnote continued in next column.}

37 See, e.g., reg. section 1.1471-5(f)(4)(viii).
38 Actually, the statute’s exemptions for foreign insurers with domestic activities are more complicated than that. For reinsurers, there also is an exemption if the policy is signed in the United States for the issuers. There are different exemptions for (Footnote continued in next column.)

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c. Congress’s intent. Third, the extraterritorial presumption can apply on its own terms only if Congress did not express its intent to apply the tax to events outside the United States. But extraterritorial application is what the excise tax is all about: It applies only to foreign insurers that do not earn ECI.\textsuperscript{41} The excise tax statute is totally different from the statutes at issue in the earlier Supreme Court decisions: the Sherman Act, the Equal Employment Opportunity Act as originally written, or SEC Rule 10b-5. Those statutes and regulation did not by their terms target foreign transactions, and they used general terms. In contrast, the foreign insurance company excise tax does specifically target foreign persons.

The excise tax has only one domestic nexus stated in section 4372(d) and (e): The insured risk on the primary insurance must be domestic. That shows Congress thought about identifying a domestic nexus that justified the taxation of foreign persons, did so, and did not intend for a court to create another nexus requirement.

A large part of the circuit’s speculation about Congress’s intent concerned the complications that the IUA and LIIBA projected might occur if the IRS tried to collect the tax from more remote reinsurers. Since that was not the case before the court, it should not have taken such a central role in the analysis. Most likely the circuit’s strange pivot to the cascading tax theory revealed its discomfort with saying that a tax clearly aimed at extraterritorial transactions fell under the presumption against extraterritoriality.

d. Clear indication. Fourth, the circuit adopted the “clear indication” version of the presumption that the two dissents quoted above said was not reflected in the case law when all relevant precedent was considered. And Scalia agreed that there is no clear indication rule.

In any event, Congress did give a clear indication: It wrote the statute clearly to apply to foreign insurers. The D.C. Circuit had already decided that the presumption should apply to re-reinsurance. Re-reinsurance will be the third insurance contract on an underlying risk. The reinsurance business was known to be international in 1942 when the tax originated. Congress aimed the statute at foreign reinsurers. What more indication do you want?

e. Follow the risk. Fifth, regarding the “cover” argument, the circuit went back through prior versions of the statute to reach the conclusion that the definition of reinsurance did not follow the risk.

The court refused to give primary importance to the words of section 4372(f) that define reinsurance as “with respect to” risks covered by the primary contracts of insurance.

f. Let’s get our story straight. Sixth, after hinging its analysis entirely on the near-conclusive presumption, the opinion’s final paragraph states that the circuit has interpreted the statute in a manner that is the “most faithful reading of the text.” But the court just got through telling us that it could not interpret the text and had to rely on a presumption.

g. Northumberland. Seventh, the 1981 Northumberland\textsuperscript{42} opinion seems directly in conflict with the D.C. Circuit’s opinion. But the plaintiff and amici argued that the facts of Northumberland were different. They were different, in that the reinsurer filed some sort of income tax returns for the years at issue. The facts of Northumberland are confused; nevertheless that opinion stated:

\textit{In the first instance, the excise tax was withheld from the premiums ceded by the direct insurers to Northumberland as reinsurer. This served to equalize Northumberland’s position as a foreign reinsurer. In the second instance, the tax was imposed on the premiums as transferred to AIM RE as a separate foreign reinsurer, or in this case, retrocessionaire. Imposition of the tax to this transaction thus serves to further the legislative policy.\textsuperscript{43}} [Emphasis added.]

This quotation shows that the Northumberland court approved the same double excise tax (totaling 2 percent) that the D.C. Circuit in \textit{Validus} said was impossible. The D.C. Circuit said that the Northumberland opinion did not consider the presumption against extraterritoriality. Of course, the presumption did not exist in its retooled form in 1981. Nevertheless, the earlier opinion interpreted the statute and allowed cascading.

h. No conflict of laws. Eighth, the extraterritoriality presumption originated in part to coordinate the law of nations and to enforce a 16th-century view of sovereign power: Each nation thinks it can determine the consequences of conduct within its own borders, and without conflict-of-laws principles, which the presumption is, chaos or conflicting rules reign.\textsuperscript{44} That is the context of the banana case, the EEOC case, and the Rule 12(b)-5 case.\textsuperscript{45}

\textsuperscript{41} \textit{Aramco} ignored a less clear indication that Congress intended the statute to apply to citizens employed abroad. The statute did not apply to aliens employed abroad.


\textsuperscript{43}Id. at 78-79.

\textsuperscript{44}\textit{See} Kramer, supra note 16, at 188.

\textsuperscript{45}Another prominent citation in the history of the presumption is \textit{Foley Bros. Inc. v. Filardo}, 336 U.S. 281 (1949). But it, too, involved a generic requirement with no textual indication of foreign application and legislative history plus prior attorney (Footnote continued on next page.)
But choice of law is not needed in federal taxation, as illustrated by the U.S. choice to tax the worldwide incomes of citizens and residents. To the extent conflicts arise in taxation, the remedy of choice is the tax treaty, which can and does apply to the insurance excise tax. Therefore, the Justice Department should have argued that the presumption was simply inapplicable and had never been applied by the Supreme Court to a federal tax.

V. Chevron

On appeal, the Justice Department asserted for the first time that under the Chevron doctrine, the court should give deference to a Treasury regulation under section 4371. The D.C. Circuit refused, partly because the government did not show that Treasury had considered the presumption against extraterritoriality in adopting the regulation — in 1970. If the court was right, this could be a major addition to the reasons to crowd out Chevron deference, but the circuit was wrong on several grounds.

The government wanted to rely on reg. section 46.4371-2(c)(2), which melded the definition of reinsurance into the taxing section in the normal way.\(^{46}\) It was adopted in 1970, before Chevron, and before Rehnquist had revived the presumption. As the Justice Department brief pointed out, that regulation harmonized the taxing part of the statute and the definitional part by logically imposing the excise tax on reinsurance of a risk whose underlying primary insurance contract was otherwise identified in the statute. This is the interpretation that the trial court rejected completely and that the circuit said “fits awkwardly.”

For this new Chevron requirement, the D.C. Circuit relied again on Scalia’s opinion in Morrison, but it did not get the cite exactly right. Scalia said only that the Court would not give deference to agency rulings that relied on case law that it had already rejected because the cases, not the rule, did not rely on the presumption.

Maybe few Treasury regulations run the risk of not considering the presumption. Or do they? For example, reg. section 1.1012-1(a) says the basis of property is its cost, and we assume that applies to foreign persons that have not yet touched the U.S. tax system. But does it? Should Treasury have investigated that point when it wrote the regulation in 1957? Stay tuned for an article on the tax attributes of foreigners.

VI. Extraterritoriality of U.S. Tax Generally

A. A Common Issue

The D.C. Circuit wrote as if there were no federal tax context surrounding the extraterritorial tax issue, and yet there is a context. For starters, the income tax assumes that all of subtitle A has worldwide effects. Section 7701(a)(14) defines taxpayers as any persons subject to any internal revenue laws, which include the insurance excise tax. The phrase “subject to” is generally understood to mean potentially subject to.\(^{47}\)

New York University professor Harvey P. Dale used to say that a baby born today in China is a U.S. taxpayer.

Every preexisting foreign corporation that is acquired by a U.S. citizen or resident springs into the U.S. tax system with adjusted tax basis for its assets, earnings and profits, etc., even if its prior owners never expected the code would require that bookkeeping. That means those foreign corporations were subject to U.S. tax laws before they became liable for U.S. taxes.\(^{48}\)

If there were no tax history to be wiped out, corporate buyers of the stock of foreign corporations from corporate sellers would not be so keen to make section 338(g) elections. Therefore, the income tax is necessarily assumed to have extraterritorial effect without anyone saying so, thinking about it, or considering the extraterritorial presumption.

There is also an extraterritorial context for federal excise taxes. In fact, the tax on foreign insurance was before the Supreme Court in 1994, when IBM Corp. contested its application to foreign insurance bought by IBM’s foreign subsidiaries on goods purchased by the subsidiaries from IBM’s U.S. plants.\(^{49}\)

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bought by foreign corporations from foreign insurers was assumed, and the case was decided on the basis of the constitutional prohibition against tax on exports.

Likewise, the Supreme Court assumed Congress intended Prohibition and its taxes to apply to foreign ships in U.S. waters, but Treasury did not attempt to apply them beyond those waters.50

The most important foreign excise tax cases involved foreign-built yachts, and they produced several important decisions of the Supreme Court before World War I. The government cited one of those decisions in its Validus brief regarding the taxpayer’s constitutional claim, but the citation generated no interest.

B. The Foreign Yacht Tax

The cited case was Bennett,51 which involved a 1909 excise tax imposed on the use of foreign-built yachts. The tax was assessed against several wealthy yacht owners, who mounted a series of mostly unsuccessful court challenges. Like the insurance excise tax, the yacht excise tax was aimed directly at a foreign target. Mr. Bennett argued that because his yacht at all times remained outside the jurisdiction of the United States, it was not subject to the tax.

Chief Justice Edward D. White Jr. rejected the argument, finding that the statute referred to use and did not restrict that to use inside the United States. Had White known about the presumption against extraterritoriality or thought it applicable, he might have said that the statute did not say where the use should be and that the presumption precluded foreign use. But he did not.

However, another taxed yacht owner, Mr. Goelet, objected that not only was his yacht abroad, but so was he, and the tax should not apply to a nonresident citizen.52 Goelet won because the Court’s experience up to that point was that Congress never undertook to tax citizens abroad. The opinion acknowledged the contrary approach of the new 1913 income tax but reasoned it was an exception that proved the rule.

The Goelet opinion did not rely solely on the inference from prior practice, which might be analogized to the presumption. It went on to point out that the yacht tax statute directed that the tax be collected by the collector of customs in the district nearest to the residence of the yacht owner. This was proof in the text of the statute that Congress expected the taxpayer to be a resident, and so the foreign-built yacht excise tax did not apply to a nonresident citizen.

The yacht tax decisions really are the closest analogues to the insurance excise tax case. In those cases, the Supreme Court did not use a presumption but an inference from prior congressional practices. The Court did not rely solely on the inference but also on the text of the statute. Even though the excise tax was a tax on use, the use did not have to be in the territory of the United States. That is precisely the way Holmes conceived the presumption against extraterritoriality and the way it was used up to 1991. The Aramco and Morrison opinions at least give lip service to that approach. The problem comes when lower federal courts that perhaps do not understand the nuances of the presumption ram it down as a positive rule of law.

VII. Back to the Revenue Ruling

This report began with the current event, Rev. Rul. 2016-3. The ruling states that the IRS will not apply the 1 percent tax to foreign-to-foreign reinsurance when the reinsured company is not earning ECI, either as a primary insurer or as a reinsurer. So the Bermuda reinsurance companies can be home free so far as the insurance excise tax is concerned.

A likely explanation for Rev. Rul. 2008-15 and the assessment against Validus is that the IRS has other reasons to be concerned about some Bermuda reinsurers. They may operate like hedge funds but are not treated as passive foreign investment companies; these have been on the IRS’s radar for some time.53 Presumably Validus is not such a company because it is public.54

This may suggest another reason why the IRS gave up on Validus: It was a sideshow to the main concern with foreign insurers.

VIII. Conclusion

Speakers on the art of negotiation say, “You have to care, but not too much.” The same is true for the IRS.

The IRS always thinks it is right, but sometimes it is not. At other times, it is right but loses anyway. The organization has to take a philosophical approach to the losses or else someone would go nuts.

Tax professionals have a completely different mind-set. You usually can’t worry about which argument is more right or wrong; you must argue

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50Cunard S.S. Co. v. Mellon, 262 U.S. 100 (1923).
54Indeed, it has been suggested that as a real operating insurer, Validus has aided the hedge fund insurers. See Sonali Basak and Selina Wang, “Wyden Targets Hedge Funds in Reinsurance Tax Legislation,” 123 DTR G-5 (June 26, 2015).
for the taxpayer’s position as an advocate, although it really helps to be right.

But courts ought to have their own mind-set. They have an institutional obligation not to be snowed under by great advocacy. The Tax Court has recognized it has the power to decide a case on grounds not even argued by the parties:

Thus, the parties cannot prevent the Court from deciding the case upon what it considers to be the correct basis, simply by failing to plead correctly, or by attempting to control the issues to be considered by the Court through admission and/or stipulation. It is the Court’s right and obligation to decide the case upon what it considers to be the correct application of the law, based upon the record presented, whether the parties have properly pleaded the controlling issues or not.55

I seriously doubt that the D.C. district court and the D.C. Circuit would have held the way they did if they had had a more regular diet of federal tax cases. They would have sensed, as did White in the yacht excise tax cases in 1914, that tax laws normally have extraterritorial effect, particularly when the section at issue targets solely foreign insurers.

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Transfers of Intangibles to an Existing Partnership

By W. Eugene Seago and Kenneth N. Orbach

Under section 704(c), “income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.” The rationale for section 704(c) is that “special rules are needed to prevent artificial shifting of tax consequences between partners with respect to pre-contribution gain or loss.” Thus, when pre-contribution gains and losses (the difference between the value of the property contributed and the contributing partner’s basis in the property) are realized, those gains or losses should affect only the contributing partner's basis in the property, and not the noncontributing partners.

Changes in value that occur after the contribution of the property are subject to the general rules for partnership allocations. This article analyzes the possible application of section 704(c) principles to the amortization of the zero-basis intangibles transferred to a partnership for an interest in the partnership profits, losses, and capital.

A. Contributed Property Subject to Cost Recovery

When depreciable or amortizable property is contributed to a partnership and the partnership uses the property in the operations of the business rather than disposing of it in a taxable transaction, the cost recovery deductions must be allocated between the contributing partner and the noncontributing partners so as to account for the difference between the property’s basis and FMV at the time of the contribution. The allocation of the asset’s built-in gain to the contributing partner is accomplished indirectly. Under the “traditional method,” as prescribed in the regulations, in effect, the built-in gain or loss from depreciable or amortizable property is allocated to the contributing partner through adjustments to the annual cost recovery. That is, the regulations require the noncontributing partner to be allocated tax depreciation to the extent of book depreciation (using FMV) of the asset and the contributing partner to be allocated the remainder of the depreciation taken for tax purposes. For example, if a partner (T) with a 50 percent interest in profits contributes amortizable or depreciable (by the straight-line method) property with a basis of $6,000, FMV of $10,000, and a remaining cost recovery period of 10 years, then each year the noncontributing partner will be allocated $500 [($10,000/10) x 0.5] cost recovery, and the contributing partner will be allocated the remaining $100. Over the life of the asset, the cost recovery will reduce T’s share of capital.

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the income by $1,000, and the noncontributing partners’ income would be reduced by $5,000. Assuming the partnership uses the property for the remainder of the 10-year cost recovery period, the contributing partner will be allocated $4,000 [(5000-100) x 10 = $4,000] more income than the noncontributing partners. Thus, T’s built-in gain is not recognized at the time of the transfer but is allocated at the rate of $400 per year over the 10-year cost recovery period.

In the example above, T was allocated only $1,000 of depreciation in arriving at taxable income, even though his 50 percent share of economic depreciation was $5,000. This $4,000 difference — his built-in gain — was all recognized over the cost recovery period for the contributed property. The drafters of the regulations could have instead provided that some or all of the difference between basis and value be taken into account when the partner’s interest is liquidated. Thus, the regulations could have permitted T to deduct $3,000 in depreciation (50 percent of the partnership’s basis) over the life of the asset, while reducing his book capital account by $5,000 (50 percent of FMV). T’s liquidating distribution would have been $10,000 - $5,000 = $5,000, but his basis would have been $6,000 - $3,000 = $3,000. At liquidation, T would have had a $2,000 gain. The additional $2,000 in depreciation ($3,000 rather than $1,000) would have been countered by the $2,000 gain at liquidation, and the contributed asset would have reduced T’s total taxable income by $1,000 under either method.

Instead, the drafters of the regulations opted for an approach that does not defer the adjustments until liquidation. However, the ceiling rule creates an exception.

1. The ceiling rule. With the traditional method, the complete allocation of the built-in gain during the cost recovery period may be prevented by the ceiling rule, which is a product of the regulations. According to this rule, “the total income, gain, loss, or deduction allocated to the partners for a tax year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year.”

Suppose T has property with 10 years remaining in its cost recovery period, a basis of $4,000, and a FMV of $10,000. When T contributes this property for a 50 percent interest in the partnership capital and profits, only $400 in depreciation is deductible each year, all of which must be allocated to the noncontributing partners.11 While the correct answer might appear to be an allocation of $500 of annual cost recovery to the noncontributing partners and $100 of income ($500 - $400) to the contributing partner, the ceiling rule prohibits the allocation of more depreciation than the partnership can recognize ($400 each year in the example). This will result in the correct answer in terms of total income: T will recognize all of the built-in gain in this example because of the application of the accounting for the partners’ bases, capital accounts (with potential character of income issues), and gain and loss at liquidation. However, a portion of the adjustment is deferred until T’s interest in the partnership is liquidated, as will be seen below.

Partners recognize taxable income from partnership operations and also generally from gain or loss from the liquidation of their interest: liquidating (cash) distribution - tax basis = gain or loss.9 A partner’s book capital account determines what the partner will receive when all of the partnership’s assets are sold for book value, all of the liabilities have been paid, and the partnership is liquidated.10 The partner’s book capital account is increased by the FMV of property he contributes to the partnership, while the calculation of the partnership’s taxable income is computed using the partner’s basis in the contributed property.11 The book cost recovery deduction, calculated using the FMV at contribution, reduces that partner’s capital account. The partner’s basis in the partnership (outside basis) is increased by his basis in the contributed property (rather than FMV) and his share of taxable income. The cost recovery deductions used to compute taxable income are calculated using the partner’s basis in the contributed property.12 Thus, the built-in gain is “booked” when it is contributed, before the gain has been realized, and must not be booked a second time when the gain is actually realized. Once the cost recovery process is complete, capital and basis calculations will be brought into agreement — unless the ceiling rule applies, in which case the accounting systems are not harmonized, potentially, until the partner’s interest is liquidated.

Returning to the cost recovery example, T contributes an asset subject to cost recovery that has a basis of $4,000 and a FMV of $10,000. The other partner, B, contributes $10,000 in cash. The partnership has $20,000 in revenue from operations and $10,000 in expenses, other than cost recovery. At the end of the remaining 10 years of its cost recovery

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7Reg. section 1.704-3(b)(1).
8Reg. section 1.704-3(b)(2), Example 1(ii).
9Section 731.
11Section 723.
12Section 168(i)(7).
period, the equipment has no value, and the partnership’s only asset is $20,000 cash:

**Table 1**

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<td>Capital contribution from B</td>
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<td>Less cash expenses</td>
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The partners’ capital accounts must be reduced by the book depreciation over the remaining depreciable life of the asset. B’s correct share of depreciation is 0.5 x $10,000 = $5,000, but the ceiling rule limits the deduction to $4,000. The results of applying the traditional method are presented below:

**Table 2**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Book Capital</strong></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Revenue less cash expenses</td>
<td>$5,000</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>-$5,000</td>
</tr>
<tr>
<td>Ending capital = liquidating distribution</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Tax Basis</strong></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$4,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Revenue less cash expenses</td>
<td>$5,000</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>-$4,000</td>
</tr>
<tr>
<td>Operating taxable income</td>
<td>$5,000</td>
</tr>
<tr>
<td>Outside basis</td>
<td>$9,000</td>
</tr>
<tr>
<td>Liquidating distribution (cash)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Gain (loss) at liquidation</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total taxable (operations + liquidation)</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

T contributed property with a basis of $4,000 and a FMV of $10,000, and he received $10,000 at liquidation. T’s total taxable income was $6,000, the correct amount, but the operation of the ceiling rule deferred $1,000 of gain until the partnership liquidated. B contributed property with a basis and value of $10,000 and received from the partnership $10,000; therefore, B’s total gain was $0. Economically, B’s share of depreciation was $5,000, but the ceiling rule limited B’s deduction to $4,000. As a result, B was taxed on $1,000 from operations that was not “real” income, but he was allowed an “unreal” loss at liquidation, which may be a capital loss. Thus, the ceiling rule distorts the timing of income and may also affect the character of the income (by shifting between income from operations and capital gain from liquidation).

As a general matter, the ceiling rule applies whenever the contributing partner’s percent interest in partnership profits is less than the appreciation in the contributed property as a percentage of the property’s FMV. For example, there would be a ceiling problem if a contributing partner with a 10 percent interest contributed property that was appreciated by 15 percent. When this happens, the noncontributing partners cannot get their correct share of cost recovery under the traditional method. As a result, the contributing partner and the noncontributing partners will have deferred gains and losses.

The shift is extreme when the contributing partner has a zero basis in the property. Appreciation in this case is 100 percent of the property’s value, and the contributing partner’s share of the profit is less than 100 percent. Assume in the above example that the contributing partner, T, has a zero basis in property with a FMV of $10,000. The partners agree that the property T contributed has a limited life and no value at the end of the relevant time period. Therefore, for book purposes, the $10,000 value of the asset will be allocated to the partners as cost recovery. T would recognize a total of $10,000 in income ($10,000 liquidating distribution - $0 asset basis): $5,000 taxable income from operations and $5,000 gain at liquidation. B, who contributed $10,000 in cash and received $10,000 at liquidation, would recognize $5,000 in income from operations and a $5,000 loss at liquidation. These calculations are presented in Table 3.

Thus, under the traditional method, if the ceiling rule applies, the difference between the noncontributing partner’s cost recovery deduction for book and cost recovery for tax becomes a loss at liquidation. Conversely, the difference between the contributing partner’s cost recovery deduction for book and cost recovery for tax becomes a gain at liquidation.

As discussed above, when the ceiling rule does not apply, none of the effects of the built-in gain are deferred until liquidation; rather, the built-in gain is spread over the cost recovery period. There seems little justification for this incongruity that the rule introduces. As will be seen below, the regulations

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14Section 731(a).
16This appears to be a reasonable method because the partners agree that the allocations will actually affect what the partner is to receive at liquidation. Reg. section 1.704-1(b)(2)(iv)(g)(3). See Monte A. Jackel and Shari R. Fessler, “The Mysterious Case of Partnership Inside Basis Adjustment,” Tax Notes, Oct. 23, 2000, p. 529.
provide alternative elective methods that prevent deferral of the gain until liquidation.

2. Traditional method with curative allocations. The regulations allow partners to avoid the distortions of the ceiling rule by making a “curative allocation”: an allocation of other income, gain, loss, or deduction for tax purposes that differs from the partnership’s allocation of the corresponding book item. However, these corrective allocations are subject to vague tests for reasonableness, and there must generally be a sufficient amount of other income or deductions to complete the adjustment. The simpler adjustment process is provided in the “remedial allocation method.”

3. Remedial allocation method. Under this method, the partnership creates an item of income or deduction to correct the noncontributing partner’s taxable income and creates an offsetting item of income or deduction of the same character for the contributing partner. Thus, in the previous example of contributed property with a basis of $4,000, a FMV of $10,000, and 10 years remaining on a 15-year cost recovery period, the noncontributing partner would be allocated an additional $1,000 of deductions ($200 in each of years 11-15), instead of recognizing a $1,000 loss at liquidation, and the contributing partner would be allocated an additional $1,000 of income ($200 in each of years 11-15), instead of recognizing a $1,000 gain at liquidation.

The use of the traditional method, the traditional method with curative allocations, or the remedial allocation method is elective. In the discussion below, it will be presumed that the remedial method has been elected.

4. Zero-basis depreciable property and the remedial method. When depreciable or amortizable property contributed to the partnership has a zero basis and a positive FMV, the ceiling rule applies. Assume that T contributes depreciable property with a zero basis and $750,000 FMV to Large Partnership for a 25 percent interest. The partnership’s tax basis in the contributed property is zero, but T’s book capital account will be increased by $750,000, the FMV of the property. Assume that Large Partnership had assets with adjusted basis and value of $2.25 million before the contribution, and assume that book depreciation of the contributed property on a straight-line basis over 15 years is reasonable for purposes of the section 704(b) capital account maintenance rules. Because the property contributed by T has built-in gain, section 704(c) applies, and tax items for the property must be allocated to reduce the book-tax difference. The partnership will allocate the $750,000 of book depreciation by giving $187,500 to T and $562,500 to the legacy partners, whether Large Partnership adopts the traditional method or remedial. Under the traditional method, there would be zero tax amortization, as befits the property’s zero basis. Thus, even after 15 years, because of the ceiling rule, T’s tax and capital accounts would be unequal ($0 and $562,500, respectively), as would be the legacy partners’ ($2,250,000 and $1,687,500, respectively), and the goal of section 704(c) would not yet be attained.

If the remedial method were elected, there would be remedial items of negative $562,500 allocated to the legacy partners (equal to their book depreciation) over 15 years and a corresponding positive $562,500 of remedial items allocated to T. T’s tax and book capital accounts would be equal ($562,500), as would be those of the legacy partners.

Table 3

<table>
<thead>
<tr>
<th></th>
<th>Book Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>T</td>
</tr>
<tr>
<td>Equipment</td>
<td>$10,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Revenue less cash expenses</td>
<td>$5,000</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>-$5,000</td>
</tr>
<tr>
<td>Ending capital = liquidating distribution</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Basis</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>$0</td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Revenue less cash expenses</td>
<td>$5,000</td>
</tr>
<tr>
<td>Depreciation on equipment</td>
<td>$0</td>
</tr>
<tr>
<td>Operating taxable income</td>
<td>$5,000</td>
</tr>
<tr>
<td>Outside basis</td>
<td>$5,000</td>
</tr>
<tr>
<td>Liquidating distribution (cash)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Gain (loss) at liquidation</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total taxable (operations + liquidation)</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

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Footnote continued in next column.

17 Reg. section 1.704-3(c)(1).
18 Reg. section 1.704-3(d)(1) and (3).
19 Reg. section 1.704-3(d)(2) requires book depreciation to be computed differently under the remedial method than under the traditional method (with or without curative allocations).

Here the contributed property is 15-year property with 10 years remaining. For book purposes, $4,000 (the amount of tax basis) is recovered over 10 years just like for tax depreciation, and the remaining $6,000 is treated as newly purchased property with a 15-year life. Assume straight-line depreciation is chosen. Thus, there is $800 of book depreciation for each of the first 10 years ($4,000/10 + $6,000/15) and $400 book depreciation for each of years 11-15.

20 Reg. section 1.704-1(b)(2)(iv)(b).
21 Reg. section 1.704-1(b)(2)(iv)(g)(3), last sentence.

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Conceptual and technical problems arise if the zero-basis property contributed by T is not depreciable or amortizable in T’s hands. Would the property be non-amortizable in Large Partnership’s hands for tax or book purposes? We consider this situation next.

5. Intangibles and the remedial method. Assume that the zero-basis property contributed by T to Large Partnership is intangible (such as goodwill, workforce in place, or client files). This is typically the case with the assets of a service business. If the business assets were sold, the amount paid for the intangibles would generally be subject to amortization under section 197 by the purchaser. But if they were contributed, as discussed above, the adjustments caused by the ceiling rule can result in deferral of the built-in gain until the partner’s interest is liquidated. The remedial method, which is elective, can eliminate the deferral but can have significant unfavorable tax consequences for the contributing partner.

Assume T is the sole proprietor of a professional practice and merges his practice into Large Partnership. T does not transfer any tangible assets, but he has a “stable of clients,” for which his annual billings are $750,000. These clients are expected to follow him to Large Partnership. Under the partnership agreement, all of the fees earned from the former proprietorship’s clients after the merger will be partnership income. Assume that a proprietorship will typically sell for one-time annual billing plus the book value of the tangible assets (approximately FMV). Under the one-year-billing rule of thumb, T transfers self-created goodwill and other non-amortizable intangibles with a value of $750,000. T has a zero basis in the intangibles. T receives a 25 percent interest in Large Partnership’s capital, profits, and losses. In accordance with the capital account maintenance regulations, T’s partnership book capital account begins at $750,000. Under sections 722 and 723, T’s initial tax (outside) basis is zero (assuming the partnership had no liabilities), and the partnership’s basis in the intangibles is zero. Assume that Large Partnership had assets with adjusted basis and value of $2.25 million before the contribution and that the anti-churning rules do not apply.

Because the value of the intangibles exceeds T’s basis at the time of the transfer, the goodwill is non-amortizable in T’s hands. In accordance with the traditional method, and the section 704(c) goal would be attained.

6. Section 197. The legislative history of section 197 reveals that Congress was concerned with the disparate amortization of purchased intangibles. Taxpayers who could afford expert testimony to establish the useful life of an intangible were permitted to amortize the asset, while those who could not afford to challenge an IRS assertion that a particular asset did not have a determinable useful life were effectively denied this benefit. Section 197 was intended to resolve this issue by generally permitting taxpayers to amortize the cost of a purchased intangible over 15 years, regardless of the asset’s economic life.

Under section 197(c)(2), amortization of self-created intangibles is generally not permitted. In our example, the proprietor’s intangibles are self-created, and thus the contributing partner would not be allowed an amortization deduction, even if he had a nonzero basis in the asset. Because the partner’s tax attributes of property contributions generally carry over to the partnership, the question arises regarding whether the non-amortizable intangibles in T’s hands remain non-amortizable for tax and book purposes once transferred to the partnership. The regulations are helpful but do not provide a clear answer. According to reg. section 1.197-2(g)(4), transferred intangibles are generally ineligible for amortization unless the intangibles could be amortized by the contributing partner. In our case, the proprietorship intangibles were self-created and are therefore not amortizable. This is pure aggregate theory reasoning. The regulation, however, provides for an election that appears to be based on entity theory, which applies even when the person who contributed the intangible is ineligible for an amortization deduction:

If a partner contributes a section 197 intangible and the partnership adopts the remedial allocation method for making section 704(c) allocations of amortization deductions, the partnership may make remedial allocation deductions with respect to the contributed section 197 intangible. [Emphasis added.]

---

23Reg. section 1.704-3(a)(3).
24See generally reg. section 1.704-3.
26See e.g. sections 722 and 168(j)(7).
As will be seen, under the election, the noncontributing partner can claim amortization deductions just as if the partners purchased their interests, but at an additional tax cost to the contributing partner. The added cost is the result of applying the remedial method to address the ceiling problem. According to this method, if the ceiling rule causes:

the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.27

The technical bone of contention is whether the non-amortizable intangible contributed by T remains non-amortizable for book purposes in the partnership’s hands. In other words, does reg. section 1.197-2(g)(4)(ii) cause the contributed non-amortizable intangible to be non-amortizable for book purposes as well as for tax purposes (unless remedial is elected)? One leading commentator says “yes.”28 If correct, Large Partnership would have only two choices: Do not amortize the intangible for book and tax purposes, or use the remedial method. We disagree with this flat prohibition of book amortization under the traditional method. In our example the partners agree that the intangibles have a limited 15-year life, and thus for book purposes the decline in value should be reflected in the partners’ capital accounts: After the 15-year stipulated economic life, the book values of the interests should reflect the agreed zero value of the intangible.

Others believe reg. section 1.197-2(g)(4)(ii) applies only for tax purposes and not for book purposes: The zero basis non-amortizable intangible cannot be amortized for tax purposes (unless remedial is elected) but can be amortized for book purposes even without adopting the remedial method. Of course, if the non-amortizable intangible had a nonzero basis in T’s hands (and therefore in Large Partnership’s hands) and the capital account maintenance rules were followed, reg. section 1.704-1(b)(2)(iv)(g)(3) would preclude book amortization.

In our analysis, we will compare the results of allowing book amortization under the traditional method with the results of amortization (tax and book) under the remedial method. In either case, the ceiling rule applies because the tax amortization is zero, while the total book amortization is $50,000 per year, and the noncontributing partners’ book allocation of amortization is $750,000, and T will be allocated a 25 percent share. Total partnership income would be unaffected — only the allocation among the partners.29 The net result of applying the remedial method is equivalent to the contributing partner selling the intangible in installments, except that the contributing partner’s corresponding income would all be ordinary.30 This is consistent with reg. section 1.704-3(d)(2), which requires the ordinary deductions of the noncontributing partners to be matched with ordinary income to the contributing partner.

B. Section 704(c) Applied to Intangibles

Here we compare the results without amortization of the intangibles with the application of the traditional and remedial methods in the case of T contributing self-created intangibles with zero basis and $750,000 FMV to the partnership. The partnership had assets with a basis and value of $2.25 million before T’s capital contribution. T’s capital account is credited for the FMV of the intangibles, $750,000, and T will be allocated a 25 percent interest in the partnership’s profits and losses.31 Further assume that (1) the partnership has taxable income and cash flow of $200,000, (2) the partnership distributes all of its book income before amortization, and (3) the partnership agreement calls for distributions at liquidation as though the intangible has no value at the end of 15 years (and thus the amortization will reduce the amount the partner receives at liquidation). The assumption of no value is realistic because of prior experience regarding client turnover.32 Thus, the book capital accounts are maintained in a manner consistent with the partner’s interest in the partnership, and over the 15

27Reg. section 1.703-3(d).
28See Jackel and Fessler, supra note 16, at 533 notes 27 and 28, and accompanying text.
29Reg. section 1.704-3(d)(4).
30See Andrew H. Braiterman, comments on prop. reg. section 1.197-2(g)(2)(vi) (Feb. 10, 1997), which would have denied amortization of the intangibles by the noncontributing partners.
31It should be noted that if T were not given credit through his capital account for the value of the intangibles, in essence he would be shifting economic capital to the other partners, perhaps for an increased share of profits, which would raise issues under section 707.
years T will bear the burden of 25 percent (his share of profit and loss) of the loss of the intangibles’ value.

1. **Traditional method.** There is no tax amortization because the contributed property had zero basis. However, for book purposes, the value of the contributed property is amortized over 15 years.34 As seen below, over the 15 years, T must recognize $750,000 of ordinary taxable income, and at liquidation of his interest, he must recognize a $562,500 gain. No other partner is liquidated at that time. The gain will be capital unless the transaction qualifies (that is, for a general partner) in part under section 736(b)(2), and is structured accordingly, to create ordinary income to T and an ordinary deduction for the partnership. Assuming T’s gain is treated as capital gain, the partnership can make a section 754 election to increase the basis of its assets in an amount equal to T’s gain. Thus, the $562,500 represents future deductions by the partnership.

It should be noted that T’s liquidating distribution is equal to the value of his capital contribution less his one-fourth share of the amortization. The effect of the traditional method is to tax T as though he sold three-fourths of his interest in the goodwill and realized capital gain at liquidation.

2. **Remedial method.** Applying the remedial method, the original Large Partnership partners are allocated three-fourths of the amortization on T’s contributions of intangibles, 0.75 x $750,000 = $562,500, and T is allocated the same amount as ordinary gross income. Thus, over the 15 years, T’s ordinary income from operations will be $1,312,500, and he will have no gain or loss at liquidation.

The effects of the options on the contributing and noncontributing partners are summarized below:

<table>
<thead>
<tr>
<th>Table 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax — Traditional Method</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Beginning basis</td>
</tr>
<tr>
<td>Revenue</td>
</tr>
<tr>
<td>Amortization</td>
</tr>
<tr>
<td>Taxable income</td>
</tr>
<tr>
<td>Distributions</td>
</tr>
<tr>
<td>Ending basis (outside)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Book — Traditional Method</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>Contributing</td>
</tr>
<tr>
<td>Non-Contributing</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

---

33Perhaps “traditional method” is a misnomer because unlike the examples in the regulations in which the noncontributing partner is allowed a deduction, in our example there is no basis to amortize. A better heading would simply be “no amortization.”

34Reg. section 1.704-1(b)(2)(iv)(g)(3) and -3(d)(2) (the amortization period for purchased goodwill).

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It should be apparent that the noncontributing partners benefit from the amortization, but at a cost to the contributing partner, who is required to increase his taxable income by the amount of the noncontributors’ amortization deductions. Moreover, the remedial method converts what would have been traditional method capital gain at liquidation into ordinary income from operations. But...
the intangible regulations give a choice: (1) amortization with the remedial method, or (2) no amortization. Thus, the ability to apply the remedial method is an additional variable that may require negotiation between the partners.

C. Reverse Section 704(c)

In the previous examples, the contributed assets had built-in gains, but the existing assets of the partnership had no built-in gains. Consider the case in which T’s basis in the intangibles contributed is equal to their FMV ($750,000) — or T contributes $750,000 in cash — and the partnership’s non-amortizable intangibles have zero basis and FMV of $2.25 million. The partnership profit and loss formula must change as a result of T entering the partnership. The partnership can elect to revalue the original partner’s capital account to reflect the FMV of the intangibles (as well other assets) when T becomes a partner. This is a reverse section 704(c) situation, in which T is deemed to be the noncontributing partner (even though T is actually the contributing partner).

If the election is made to revalue the assets and capital, the regulations require that the same procedures for allocating tax items for a contributing partner under section 704(c) be applied to the built-in gains reflected in the original partners’ capital accounts. In our example, if the partnership elects to revalue assets when T enters the partnership, and the remedial allocation method is used, the partnership will amortize $2.25 million, treating the original partners as the contributing partners. Thus, T will be allocated 0.25 x $2.25 million = $562,500 of ordinary deductions, and the other partners will recognize $562,500 of ordinary income.

However, while the section 704(c) procedures are generally required in the forward section 704(c) situation, the application of those procedures to the reverse section 704(c) facts are generally elective on the part of the partnership. If the original partners are willing to forgo revaluation of assets and do not otherwise amend the agreement to allocate built-in gains to themselves — and thus potentially transfer a share of built-in gains to themselves — and thus potentially transfer a share of built-in gains to the new partner — then, upon first impression, the regulations do not explicitly provide for immediate tax consequences. That is, a reverse section 704(c) accounting can be avoided, but there must be a proper accounting for the forward section 704(c) transaction. But when rational persons surrender value to another party, the IRS can look to the

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36Reg. section 1.704-1(b)(2)(iv)(g)(1).

### Table 6

<table>
<thead>
<tr>
<th>Tax — Remedial Method</th>
<th>Contributing</th>
<th>Non-Contributing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning basis</td>
<td>$0</td>
<td>$2,250,000</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Net income before amortization</td>
<td>$750,000</td>
<td>$2,250,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Remedial amortization</td>
<td>$562,500</td>
<td>$-562,500</td>
<td>$0</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$1,312,500</td>
<td>$1,687,500</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Distributions</td>
<td>$-750,000</td>
<td>$-2,250,000</td>
<td>$-3,000,000</td>
</tr>
<tr>
<td>Ending basis (outside)</td>
<td>$562,500</td>
<td>$1,687,500</td>
<td>$2,250,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Book — Remedial Method</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning capital</td>
<td>$750,000</td>
<td>$2,250,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Net income before amortization</td>
<td>$750,000</td>
<td>$2,250,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Amortization (0.25 x $750,000) + (0.75 x $750,000)</td>
<td>-$187,500</td>
<td>-$562,500</td>
<td>$-750,000</td>
</tr>
<tr>
<td>Book income</td>
<td>$562,500</td>
<td>$1,687,500</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Distributions</td>
<td>$-750,000</td>
<td>$-2,250,000</td>
<td>$-3,000,000</td>
</tr>
<tr>
<td>Ending capital = liquidating distributions</td>
<td>$562,500</td>
<td>$1,687,500</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Less, tax outside basis</td>
<td>-$562,500</td>
<td>-$1,687,500</td>
<td>$-2,250,000</td>
</tr>
<tr>
<td>Gain or loss from liquidation (capital)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Taxable — operations</td>
<td>$1,312,500</td>
<td>$1,687,500</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Total taxable income (all ordinary income)</td>
<td>$1,312,500</td>
<td>$1,687,500</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>
motivation for the transfer and may find disguised exchanges or compensation.39

D. Forward and Reverse Section 704(c)

Continuing the example, if the contributed property is intangible and the partnership has intangibles with FMVs greater than their bases, all of the parties may have additional income and offsetting deductions. Assume T and the partnership have a zero basis in their intangibles and respective values of $750,000 and $2.25 million. As a forward section 704(c) transfer, T would recognize an additional $562,500 of ordinary income (0.75 x $750,000). As a reverse section 704(c) transfer, viewing T as the noncontributing partner, T gets $562,500 in ordinary deductions (0.25 x $2.25 million); thus, the amortization would not affect T’s ordinary income and capital gain.

The contributing partner’s share of profit and loss may differ from his contributed intangibles as a proportion of the total partnership’s zero-basis intangibles. This would change the benefits and burdens of the election to use the remedial method. For example, assume T is to receive 25 percent of the profits and losses but that his contributed zero-basis intangibles are 30 percent of the total of the partnership’s intangibles. Therefore, the total value of the intangibles is $750,000/0.30 = $2.5 million, and the value of the partnership’s intangible before the transfer is $2.5 million - $750,000 = $1.75 million. Under the election, T would be allocated $562,500 [(1 - 0.25) x $750,000] in additional income and $437,500 (0.25 x $1.75 million) in amortization deductions — a net increase in ordinary income of $125,000 and an equal reduction in capital gain. Conversely, the legacy partners would be allocated $437,500 in additional income and $562,500 in additional deductions.

39 See, reg. section 1.704-1(b)(5), Example (14)(iv). The timing of the shift (e.g., at T’s admission or at a subsequent sale) is unclear.

E. The Partners’ Choices

The fact that successful service businesses typically have valuable non-amortizable intangibles with no basis means that transferring ownership of those intangibles to a partnership has section 704(c) implications. Moreover, because the intangibles often have a zero basis, the ceiling rule comes into play. The section 197 regulations provide the partner and partnership with options: amortize using the remedial method, or do not amortize for tax purposes.

From a policy perspective, if the underlying purpose of section 704(c) is worthy and the remedial method is consistent with the purpose of that section, why should the partner who contributes zero-basis intangibles be permitted to defer built-in gains through the use of the traditional method? While the zero-basis property contributor can attain deferral, a partner who contributes property with less appreciation (that is, appreciation as a percentage of contributed value that is less than his profits ratio) cannot defer gain until liquidation.

F. Other Conclusions

The ceiling rule will always apply to contributions to a partnership of intangibles with a zero basis and a positive FMV. As demonstrated above, if the remedial method is not elected, much of the transferor’s built-in gain will be deferred until liquidation. On the other hand, when the contributing partner’s share of the profits is equal to or greater than the built-in gain as a percentage of the value of the contributed property, the entire built-in gain will be included in the transferor’s income during the cost recovery period. Moreover, all of the transferor’s built-in gain will become ordinary income. What is the right answer? Deferral with capital gain, or no deferral and all ordinary income? It would seem that the answer should not depend upon a difference between the partner’s profit ratio and the appreciation of contributed assets as a percentage of value.
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Limited Scope Tax Engagements Are Not as Limited as You Think

By Scott F. Hessell and Erin W. Wolf

Scott F. Hessell (shessell@sperling-law.com) and Erin W. Wolf are attorneys at Sperling & Slater PC in Chicago. Hessell co-leads the firm’s tax shelter liability practice, which pursues claims against professionals who design, market, and implement sham tax strategies.

In this article, Hessell and Wolf provide tips on how attorneys can narrow the scope of representation with clients while still fulfilling ethical duties.

There are several good reasons for attorneys and clients to have written retention agreements. In fact, they are encouraged by the American Bar Association and required by the model rules for contingency fee agreements. From an attorney’s perspective, a written retention agreement may help prevent malpractice liability by clearly defining the scope of a relationship — stating exactly what the attorney is being hired to do and, in some circumstances, detailing what the attorney is not being hired to do. These agreements may also prevent conflicts of interest by limiting relationships so as to prevent them from spilling over into areas where the attorney’s interests might not be aligned with those of the client.

Practitioners should be cautious about duties to clients that remain intact even in a contractually defined (or limited-scope) representation. Like most specialists, tax practitioners often limit the scope of representation to address a client’s tax liability for only a specific year or particular transaction under audit. Tax controversy lawyers also often want to make clear that they do not represent their client regarding any other aspects of a transaction besides the tax owed, such as potential malpractice claims of the accountant or tax return preparer who may have referred the client. This article will address potential pitfalls in defining the scope of representation and provide tips gathered from cases around the country and from our firm’s experience to assist practitioners in narrowing the scope of representation while still fulfilling ethical duties to clients.

Limitation Reasonable Under the Circumstances

Lawyers should review the rules of professional conduct (and associated comments) in their state when preparing for a meeting, drafting a letter, or creating a retention agreement that involves limiting the scope of representation. According to rule 1.2(c) of the ABA’s Model Rules of Professional Conduct (MRPC), which has been adopted in various forms by all states:

A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.1 [Emphasis added.]

According to MPRC rule 1.0(h), “reasonable’ or ‘reasonably’ when used in relation to conduct by a lawyer denotes the conduct of a reasonably prudent and competent lawyer.” Further explanation of “reasonable under the circumstances” can be found in comment 7 to MPRC rule 1.2(c):

If, for example, a client’s objective is limited to securing general information about the law the client needs in order to handle a common and typically uncomplicated legal problem, the lawyer and client may agree that the lawyer’s services will be limited to a brief telephone consultation. Such a limitation, however, would not be reasonable if the time allotted was not sufficient to yield advice upon which the client could rely.

Practitioners should be overly cautious and follow the guidelines courts have set when interpreting MRPC rule 1.2(c) (and the state counterparts to the ABA’s model rule), as discussed in more detail below.

Courts have generally upheld limitations on the scope of representation as long as they are clear, sensible, and made with client consent. See, for example, Kane, Kane & Kritzer Inc. v. Altugen2 (a scope limitation based on the course of dealing over the years was enforced when a lawyer was retained by a sophisticated client to send collection letters but not to file or discuss the suit unless requested);

1The ABA publishes a list of the applicable state rules and comments.

2Kane, Kane & Kritzer, 165 Cal. Rptr.3d 534, 537 (Cal. Ct. App. 1980).
Johnson v. Jones\textsuperscript{3} (a scope limitation was enforced when a lawyer was retained under a retention agreement to draw up a contract but not to advise on the rights under it); Delta Equipment and Construction Co. Inc. v. Royal Indemnity Co. Inc.\textsuperscript{4} (a scope limitation was enforced based on an oral agreement to defend a workers’ compensation claim but not a wage claim or any other claim, even when the attorney inadvertently mailed documents related to a wage claim); and Martini v. Leland\textsuperscript{5} (an attorney retained to consult on a pending suit against the plaintiff but not to conduct the litigation had no duty to appear for the claimant).

In AmBase Corp. v. Davis Polk & Wardwell,\textsuperscript{6} a law firm successfully litigated an IRS tax dispute but was later sued by the client for malpractice on the basis that the firm had failed to question whether an agreement entered into between the client and a related company (seven years before the attorney-client relationship was formed) may have relieved the plaintiff of the tax liability.\textsuperscript{7} The court found that the law firm was retained to litigate the amount of the tax liability with the IRS and not the issue of whether the client had underlying tax liability.\textsuperscript{8} Moreover, both AmBase and the IRS had taken the position — for approximately seven years before Davis Polk’s retention — that AmBase was responsible for all the tax obligations at issue.\textsuperscript{9}

**Informed Consent**

Under MRPC rule 1.0(e), “‘informed consent’ denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.” Comment 6 to rule 1.0 provides additional guidance:

"The lawyer must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client or other person of the material advantages and disadvantages of the proposed course of conduct and a discussion of the client’s or other person’s options and alternatives. In some circumstances it may be appropriate for a lawyer to advise a client or other person to seek the advice of other counsel. A lawyer need not inform a client or other person of facts or implications already known to the client or other person; nevertheless, a lawyer who does not personally inform the client or other person assumes the risk that the client or other person is inadequately informed and the consent is invalid. In determining whether the information and explanation provided are reasonably adequate, relevant factors include whether the client or other person is experienced in legal matters generally and in making decisions of the type involved, and whether the client or other person is independently represented by other counsel in giving the consent."

Under MRPC rule 1.2(c), the client must know and explicitly consent to the scope limitations, and the agreement limiting the representation must be clear. Johnson v. Board of County Commissioners\textsuperscript{10} (an attorney failed to consult with her sheriff client or make clear that she was representing the sheriff in his official capacity only and not also in his personal capacity); In re Samad\textsuperscript{11} (the limit on the scope of representation to a mere consulting role not including motion practice must be clearly communicated to and understood by the client); and Indianapolis Podiatry PC v. Efroymson\textsuperscript{12} (comparing the disclosure required when limiting the scope of representation to that required regarding a conflict of interest).

There are cautionary tales of lawyers who have failed in their attempts to limit the scope of services. Most often, the key problem is the lack of informed consent. In Wildey v. Paulson,\textsuperscript{13} Wildey (an attorney herself) sued her attorney, Paulson, for failing to tell Wildey that the letter Wildey wrote and sent on her own (before the retention agreement was signed) did not include the information necessary to trigger liability under a particular statute. The court upheld a finding of negligence against the attorney for failing to provide competent representation and advice.\textsuperscript{14} Even though the attorney claimed she had limited her representation to simply drafting a complaint and “appearing” in order to demonstrate the plaintiff’s intent to pursue the suit, the attorney knew (and the client did not) that the pre-suit notice letter sent by her client to the defendant did not

\textsuperscript{3}Johnson, 652 P.2d 650, 652 (Idaho 1982).
\textsuperscript{5}Martini, 455 N.Y.S.2d 354, 355 (N.Y. Civ. Ct. 1982).
\textsuperscript{6}AmBase, 866 N.E.2d 1033, 1037 (N.Y. 2007).
\textsuperscript{7}Id.
\textsuperscript{8}Id.
\textsuperscript{9}Id.
\textsuperscript{10}Johnson, 85 F.3d 489, 493-494 (10th Cir. 1996).
\textsuperscript{11}In re Samad, 51 A.3d 486, 497 (D.C. 2012).
\textsuperscript{13}Wildey, 894 N.E.2d 862, 869 (Ill. App. Ct. 2008).
\textsuperscript{14}Id. at 870.
comply with the requirements under the act. The court found that this information disparity alone can trigger liability, regardless of whether the attorney had limited the representation in her engagement letter.15

When working out the limitations on the scope of services, it is vital to inform clients when these limitations might create a need to obtain additional advice. In 

Keef v. Widuch,16 an attorney was found negligent for failing to advise the client about a potential third-party action and the attendant statute of limitations when the scope of representation by the attorney was limited to a different legal course of action.17

Even when the representation of a client is limited in the retention agreement, attorneys remain subject to the duty to provide competent representation and sound legal advice.18 How far this duty extends in the face of an agreement expressly limiting the scope of services can vary depending on the circumstances. While the available case law sheds light on how to best limit the scope of representation, with malpractice claims lurking in the shadows, it is wise to err on the side of caution and make sure that clients fully understand the limits on representation from the very start.

Limitations on the scope of representation do not always absolve attorneys of the duty to provide competent representation and sound legal advice when legal problems outside of what was agreed to are reasonably apparent:

One of an attorney’s basic functions is to advise. Liability can exist because the attorney failed to provide advice. Not only should an attorney furnish advice when requested, but he or she should also volunteer opinions when necessary to further the client’s objectives. The attorney need not advise and caution of every possible alternative, but only of those that may result in adverse consequences if not considered.19

In Nichols v. Keller,20 an attorney representing his client on a workers’ compensation claim with a limited-scope retention agreement failed to inform the client about a potential third-party tort claim against the general contractor who was on site at the time of injury.21 The client learned of the claim only after it was time-barred and sued the attorney for failing to advise him of the potential claim. The court held that the attorney was negligent and needed to have informed the client not only of the limitations on the attorney’s services but also of the possible adverse implications of the limited-scope representation.22

The Nichols court noted that an attorney should: (1) disclose that there may be other remedies that the attorney is not looking into (here, third-party tort claims); (2) disclose any (reasonably) apparent legal problems pertaining to the limited scope of services (such as statutes of limitations); (3) advise the client to consult different counsel for other aspects of the client’s legal matter; and (4) even consider noting that the client received contact information for other counsel.23 It would be wise for any practitioner limiting services to include these disclosures in the retention letter and to discuss them in meetings with the client.24 Attorneys should also consider having the client initial next to those specific aspects of the retention agreement.

Based on Nichols, it may be that as long as a firm representing a tax client in an IRS proceeding cautions the client about other remedies against third parties that the firm is not looking into and informs the client of potential statute of limitations problems (and advises the client to consult another attorney on those issues), the firm has covered itself from potential malpractice liability. Attorneys should use common sense, and if they spot something, they should say something. A key to avoiding liability in a situation like Nichols is to follow the

18
19Id. at 867. See Janik v. Rudy, Exceldor & Zieff, 14 Cal. Rptr.3d 751, 758-759 (Cal. Ct. App. 2004). In Janik, the court found that class counsel had the duty to evaluate and inform class representatives of alternate theories of recovery available to the class, even those not included in the certification order. Analogizing retainer agreements with scope limitations to the certification order, the court found that the law firm should have at least brought to the attention of the class representative “additional or greater claims that may exist arising out of the circumstances underlying the certified claims that class members will be unable to raise if not asserted in the pending action.” Id. See also in re Samad, 51 A.3d at 497-498 (a lawyer purporting to limit the scope of representation to a consultant role knew that the client’s objective in hiring him was to request a reduced sentence, yet he failed to clearly communicate the limitation and consequently had his license suspended); and in re Chavez, 299 P.3d 403, 407 (N.M. 2013) (it was unreasonable for a lawyer to limit the scope of representation solely for the purpose of negotiating a plea deal).
21Id. at 996-997. See also Johnson, 85 F.3d 489, 493-494 (10th Cir. 1996).
23Nichols v. Keller, 19 Cal. Rptr.2d 601, 608 (Cal. Ct. App. 1993); see also Janik, 14 Cal. Rptr.3d at 758-759.
24Nichols, 19 Cal. Rptr.2d 601.
25Id. at 606.
26Id. at 608.
27Id. at 609-610.
28Note that an attorney does not have to anticipate a possible malpractice action and discuss the hypothetical relief that might be available to the client. Fitch v. McDermott, Will and Emery, 929 N.E.2d 1167, 1184-1185 (Ill. App. Ct. 2010).
advice of the court on obtaining informed consent and disclose to the client what the attorney is and is not looking into, the risks associated with the limited scope of the representation, and the possibility of consulting with different counsel for issues that lie outside the scope of the attorney’s representation. Although the holding in Nichols may appear daunting, the ABA has provided helpful insight into what needs to be disclosed to obtain the appropriate informed consent:

We do not suggest that a lawyer has an affirmative duty to look for, and advise clients about collateral legal problems that are not reasonably apparent or related to the primary problem. Rather, the duty is limited to giving clients notice of reasonably apparent and related legal problems and remedies in the process of limiting the scope of the representation to exclude them. It is, therefore, part of the process of obtaining the client’s informed consent to the limits of the representation.25

In the same article, the ABA provides an example of the type of information that should be given to the client:

In interviewing the client about one legal problem (the “first problem”), it may be reasonably apparent that the client has another related legal problem (the “second problem”). The lawyer should alert the client to the second problem even though the lawyer and client have limited the scope of representation to the first problem. The lawyer should also make it clear, including in the written retainer agreement, that the lawyer is not representing the client on the second problem, and that the lawyer has advised the client to seek separate representation for that problem . . . if the client wishes to pursue it.26

Letting the client know that (a) the agreement is limited in scope, (b) some issues are not being looked into, and (c) another professional should be consulted to address those issues is the key to meeting the rules of professional conduct when limiting representation.

Put Scope Limitations in Writing

Ensuring that the limitations placed on representation are reasonable and that client consent is informed are both vital to successful scope-limited arrangements. Although not necessary in all states or in all circumstances, capturing the agreement in writing is a helpful practice, encouraged by the ABA.27 Lawyers must ensure that they are diligent not only in discussions with clients but also when committing those discussions and agreements to paper. Attorneys should be as clear as possible about the scope of representation in the retention agreement and when speaking with clients. This includes making sure the client understands what the attorney will and will not be doing, as well as the consequences of this scope limitation, and would agree to a statement such as, “Because you are not retaining me to evaluate potential malpractice claims, the statute of limitations may run on such claims if you do not obtain advice from another attorney.” A court may not believe that a client could provide informed consent without appreciating the consequences of doing so.

In some circumstances, it may be important to discuss whether and how the attorney and client can later modify the initial agreement if there is a need or desire to do so. As cases evolve, if issues arise that the attorney is qualified to handle and both parties agree to expand the relationship, the retention agreement (and other controlling documents) should be revisited and revised in writing. Otherwise, the willingness to act on matters outside the scope of the initial retention agreement could be interpreted as voiding the limits on the scope of representation. Consider including language discussing the circumstances under which the relationship will end in order to further clarify the scope of representation.

Courts routinely uphold limitations on representation in the face of malpractice actions. In these cases, detailed writings such as agreements, instructions, and disclosures can provide strong evidence against a finding of malpractice liability. In Lerner v. Laufer,28 for example, the lawyer carefully crafted a retention letter explaining the limited services he was agreeing to provide in a divorce case. The letter indicated that the attorney was retained for the purpose of reviewing a property settlement agreement between the wife and husband29 and stated that the attorney had not conducted any discovery in the case.30 When the client later claimed fraud by her husband for failing to disclose that a company, which was part of the marital estate, was about to proceed to a public offering, she sued her attorney for negligence. The court, relying on MRPC rule

26Id. at 68.
27See, e.g., MRPC rule 1.5(b) (“preferably in writing’’); comment 2 to MRPC rule 1.5 (“desirable’’); and MPRC rule 1.5(c) (“contingent fee agreement shall be in writing’’).
29Id. at 473.
30Id.
1.2(c), found no liability,31 holding that it “is not a breach of the standard of care for an attorney under a signed precisely drafted consent agreement to limit the scope of representation to not perform services in the course of representing a matrimonial client that he or she might otherwise perform absent such a consent.”32 The court suggested that it would have been better if the attorney had included a citation to the applicable rule of professional conduct (MRPC rule 1.2(c)) in the retention agreement when discussing the limitation on the scope of representation.33

**Conclusion**

When limiting the scope of representation, it is of utmost importance to advise clients of the potential claims or matters that are and are not being investigated and, further, what the attorney will and will not be doing. Because of the duties to clients, it is vital that clients know where to get the help they need for things that are outside the scope of representation but that are reasonably related to the matter. A good practice is to follow the advice of the court in *Lerner* and expressly cite the applicable state or ABA rule of professional conduct in the agreement.34 It may also be worth memorializing any other discussions concerning the scope of the relationship. One should keep *Nichols* in mind and watch for potential third-party claims or other possible legal problems related to the representation. Erring on the side of caution will serve attorneys well when defining the limits of their representation.

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31 Id. at 483.
32 Id. *See also AmBase Corp., supra note 6; Heller v. Donaldson*, No. 194219, 1998 WL 2016612, at *1 (Mich. Ct. App. Mar. 13, 1998) (upholding an agreement to limit representation to a particular business dispute, specifically excluding any potential malpractice claim against a former attorney from the contractual terms of that relationship); *Flattow LLP v. Ingalls*, 932 N.E.2d 726, 729-731 (Ind. Ct. App. 2010) (a lawyer was not liable for malpractice for not responding to a cross motion for summary judgment when the retention agreement covered bringing summary judgment motion but not defending a cross-summary judgment motion); and *Dunn v. Westbrook*, 971 S.W.2d 252, 254-255 (Ark. 1998) (an attorney hired to revise a partnership agreement solely to address tax issues was not required to include or recommend a buyout provision to ensure resolution of a dispute in the event that a partner was removed).
33 *Lerner*, 819 A.2d at 483 n.2.
34 Id.
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Can Corporate Tax Reform Build on Apple’s Proposal?

By Bill Parks

Bill Parks is a retired finance professor and founder of NRS Inc., an Idaho-based paddle sports accessory maker.

In this article, Parks examines the call for corporate tax reform and proposes sales factor apportionment as a compromise for eliminating all tax expenditures.

Introduction

Although many are calling for Congress to reform the broken corporate tax system, agreement on fixes remains elusive. A compromise is needed—a reform acceptable to business and to lawmakers across the political spectrum. Almost three years ago, in testimony before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, Apple Inc. proposed that Congress pass legislation dramatically simplifying the U.S. corporate tax system. That reform, it argued, should:

- eliminate all corporate tax expenditures;
- lower corporate income tax rates;
- implement a reasonable tax on foreign earnings that allows for free movement of capital back to the United States; and
- be revenue neutral.

In identifying those characteristics of comprehensive reform, the company stated:

Apple recognizes these and other improvements to the U.S. corporate tax system may increase the company’s taxes. Apple is not opposed to such a result, if it occurs in the context of an overall improvement in efficiency, flexibility, and competitiveness. Apple believes the changes it proposes will stimulate the creation of American jobs, increase domestic investment, and promote economic growth.¹

Republicans and Democrats agree that the corporate tax system is broken and needs to be fixed. Some Republicans want a territorial system, and some Democrats want to end deferral and tax worldwide income at domestic rates. Do compromises exist that would meet most, if not all, of Apple’s requirements and still be acceptable to both political parties? What type of resolution would they agree on?

Proposals have been presented, but they have often been contentious. Rep. Devin Nunes, R-Calif., has put forth a plan—the American Business Competitiveness Act—that has some appealing features (although it also suggests changes that are not germane to my proposal). What changes would lawmakers accept if they were free of the many individuals, companies, and institutions so invested in the current system? Given the many interested parties, the question of how to tax corporate income is inherently controversial. But there are simple solutions. Unfortunately, simple does not always mean easy.

Defining Corporate Income

When you eliminate all tax expenditures,² as Apple and several presidential candidates proposed, the result is financial, or book, income. Book income is created by taking all revenue and subtracting all expenses to give pretax income.

In the United States, the American Institute of CPAs and its rules (generally accepted accounting principles) define the appropriate revenue and expenses for a company. In most of the rest of the world, the International Accounting Standards Board and its principles (international financial


²“Corporate tax expenditures” is a euphemism for credits, deductions, and loopholes that exempt some or all corporate income from taxation—often with the best of intentions.
reporting standards) do the same. GAAP and IFRS are expected to conform soon. Allowing multinational enterprises to use either or both accounting systems would not produce substantially different measures of pretax income in a low-inflation economy. That change could cut accounting costs significantly, and there would be commensurate IRS savings, thereby meeting Apple’s call for efficiency and competitiveness. Because book income is substantially higher than today’s taxable income, the change would allow significantly lower rates.

Removing or Reducing Interest Deductions

Former Florida Gov. Jeb Bush and some current presidential candidates, as well as many respected economists, such as Douglas Holtz-Eakin, have argued for eliminating or at least reducing the interest deduction. The distortions from excessive debt capital structures substantially harm our economy and further weaken it in times of crisis. Some also assert that the government should not influence capital structure by making the cost of only one form of financing tax deductible.

There are many smart reasons for at least partially disallowing interest. For instance, Nunes wants to end the interest deduction except for financial institutions. Others would argue that removing the interest deduction might prevent financial institutions from overleveraging, which contributed to the Great Recession. To strengthen community financial institutions, it might also be appropriate to allow a partial deduction for interest on government-insured deposits. To minimize distortion, interest deductions could be reduced over a 10-year period. There is evidence that a partial interest deduction paired with a tax rate reduction would both strengthen the economic structure of business and partially insulate the economy from some of its excesses.

An argument against removing the interest deduction is the fact that many small and medium-size enterprises depend on loans and pay substantially higher rates than larger competitors. Reducing or removing the interest deduction could therefore harm those comparatively fragile companies. However, as discussed in the next section, lower tax rates for SMEs would benefit most companies much more than the interest deduction.

Graduated Corporate Tax Rates

Graduating corporate taxes to be far below the individual rates for up to $2 million in income would provide a powerful incentive for small businesses to be taxed as C corporations and to once again concentrate on retaining earnings. House Speaker Paul Ryan, R-Wis., has pointed out that the rate for small businesses is 44.6 percent in the United States versus 15 percent in Canada. For growing businesses that still elect to be taxed as corporations, the credit crunch from the high rates can be extreme.

Indeed, tax experts and economists seem unaware that the Tax Reform Act of 1986 caused many small businesses to avoid reinvesting the earnings necessary for growth by becoming S corporations or limited liability companies. TRA 1986 penalized small businesses that elected to become, or were already, C corporations by adding a surtax that brought the total federal marginal tax rate to 39 percent for income between $100,000 and $335,000. That “nasty notch” had the unintended consequences of not only discouraging C corporation formation but also causing existing small C corporations to switch to S corporation or LLC status at the first opportunity. By electing to be taxed as pass-through entities, small businesses have avoided the corporate tax, but at the same time, they have less incentive to retain the earnings that are critical to growing a successful business.

Many growing companies should be retaining earnings by being taxed as corporations. By actively encouraging businesses to become

3IFRS is required in more than 90 countries and permitted in another 25.
4The shame of GAAP is the acceptance of last-in, first-out inventory accounting. While LIFO may be indefensible, it has been in use for more than 75 years, and ending it should be made as painless as possible for the companies since it is not the fault of their current stockholders or management.
5Corporate interest expenses are a deductible expense, while dividends and returns to equity are not. The tax disparity between debt and equity financing is glaring: According to the U.S. Department of the Treasury, debt financing exposes firms to a marginal effective tax rate of -2.2 percent, compared to 39.7 percent on equity financing. This disparity considerably distorts corporate finance decisions and firm capital structure. Holtz-Eakin and Gordon Gray, “Global Competitiveness and the Corporation Income Tax,” The Heritage Foundation (Apr. 30, 2009), at 2.
6The Tax Reform Act of 1986 prevented high-income taxpayers from turning themselves into corporations because it repealed the General Utilities doctrine. Under that doctrine, a company could liquidate its assets at more than book value and pass the resulting proceeds through to stockholders without the company having to pay income tax on the gains. As a result of the repeal, any gain from liquidation is taxed twice: once at the corporate level and again at the shareholder level.
8Since 1986, while S corporations have grown at approximately 7 percent per year and LLCs multiplied manyfold, C corporations have declined by approximately 1.5 percent a year.
10There is no need to change the business form. LLCs can elect to be taxed as a corporation by submitting a simple IRS (Footnote continued on next page.)
passthrough entities, the government is failing to differentiate between companies that are really vocations, such as dental practices or dry cleaners, and entrepreneurial companies that may provide substantial future payroll and economic development.\(^1\)

Many experts believe that venture capital and other outside funding sources fill small businesses’ investment needs and that those needs are fostered by reducing the capital gains tax rate. High-tech industries, for example, do depend on outside capital, but many owners wouldn’t want outside investors, even in the unlikely event they were available. Self-financing is the norm for small business, and it is accomplished through second mortgages, home equity loans, and even credit cards. Why does this matter? Because once a business reaches a particular size, those financing methods are inadequate, and it will likely become chronically underfinanced. Businesses with the most growth potential are the ones most likely to be stymied by a lack of funds.

The tax situation actually discourages small-business growth. To encourage new C corporation formation, the corporate tax rate should be much lower — lower than individual tax rates for up to $2 million in income. The debilitating effects of capital constraints cry out for more cash flow. The need for greater cash flow is real, but the “solution” is not just inefficient but inserts the government into a company’s decision-making process. Give SMEs lower tax rates and let them decide where to spend the money to finance growth. Don’t use targeted relief such as the research credit, accelerated depreciation, or even the expensing of all capital expenditures. Instead, reduce the tax rate, particularly for SMEs. The amount of the potential reduction from removing all tax expenditures would require further analysis, but the schedule listed below would be within the ballpark.

Having a graduated rate is equally important to counter the incentives to merge companies. Although some efficiency savings (that is, job losses) are the stated reasons for mergers, the overriding reason is often the increased market power of the merged company. Buying a competitor is seldom a bad business decision. Unfortunately, except in the most egregious cases, the government agencies have given up on fighting mergers.

Further research must be done to accurately estimate the percentages necessary to achieve the neutral-revenue goal. The combination of allowing at most a partial interest deduction and equating book and taxable income might support the following tax rate schedule. To support small business and discourage mergers, tax rates might be graduated up to $100 million. The following schedule could provide the necessary incentives for growth-oriented SMEs to elect to be taxed as corporations as well as discourage some mergers:

- 15 percent up to $2 million;
- 20 percent from $2 million to $20 million;
- 25 percent from $20 million to $100 million; and
- 30 percent exceeding $100 million.

That schedule provides a lower rate for all companies but particularly for SMEs.

**Calculating the U.S. Share of Global Profits**

The United States should use sales and income figures from financial statements to allocate taxable income between jurisdictions. States define their share of taxable corporate income in different ways and so could countries.\(^1\) Other countries might choose another formula or even a different method of calculating the share of profits that could be taxed by that country. Just as the U.S. states have coexisted with many formulas, so can countries. Although the proposed system would allocate income to the United States using GAAP or IFRS, other countries should be free to massage the numbers to create their taxable base.

At one time, the most common way that states apportioned taxes included three factors: payroll, property, and sales. More recently, states have migrated to use formulas that are heavily weighted toward sales or use sales exclusively. The use of sales exclusively best meets the needs of the United States because it does not discourage investment in plant and personnel and captures destination-(sales-) related profits regardless of the source. The question of what produces profits is contentious, but many in the business community would assert that only customers produce sales and that without sales, there would not only be no profits but also no company.

**A Tamper-Proof Territorial System**

Business keeps calling for a territorial corporate tax system. And it makes sense. Companies further decry the tax rate as too high and therefore non-competitive on the world stage — and they are

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right. But is the answer a low-tax territorial system? That would be revenue-depleting on a massive scale. To apportion to the United States the profits for an MNE that may operate in many countries, one should start with global sales and apportion the share of profits in proportion to the share of sales. That could lead to lower rates and avoid increasing the deficit.

Taxing the profits from sales, often called sales factor apportionment (SFA), is a powerful tool. Although SFA might not satisfy some on the left who want to tax worldwide income, it could still be used to differentiate between domestic and foreign profits. Domestic profits might be taxed at 30 percent, and only 15 percent of foreign profits might be taxed at 30 percent, for a 4.5 percent effective tax rate. Although SFA would not satisfy those who want to tax worldwide profits at a full rate, it would more than meet Apple’s requirement of a reasonable tax on foreign earnings. Likewise, some on the right might disagree because the system is not 100 percent territorial. Whether to apply any tax to foreign sales, and the rate at which to do so, would be subject to negotiation.

While some will argue for less inclusive measurements that allow separate accounting, any disinterested observer would note that it is precisely that separation that has allowed multinational corporations to avoid paying income taxes in many of the high-tax countries of the world and instead transfer their income to low- or no-tax jurisdictions. It is estimated that the United States lost between $77 billion and $111 billion in 2012 from corporate profit shifting.

It is clear that those fighting hardest against consolidated reporting in financial statements and SFA have a vested interest in the current broken system, and that vesting is often not a financial interest but a career and reputation interest. The support of the arms-length principle by those persons also has a fatal flaw: The internal pricing of a product is subject to many legitimate rationales, and it would be unrealistic to expect a company to choose a system that results in greater profits in a high-tax country than in a low-tax country.

Some have argued that since the current system allows a credit for foreign income taxes paid, there should at least be a deduction for foreign income taxes. However, because the tax calculation starts with pretax profits, there is no reason to allow a deduction for income taxes. In a territorial system, taxes paid in one country should not reduce taxes paid in another.

### Implementing Sales Factor Apportionment

Because the percentage of sales made in the United States will determine a company’s tax liability, some companies will be tempted to manipulate that percentage. For example, a company might sell to an “independent” entity, which would then import goods for domestic sale. This and other schemes can be frustrated by a simple change in calculating U.S. sales: Rather than asking the government with proving the sales were not outside the United States, shift the burden of proof to the corporation to document the location of sales. That method is widely used by governments in other contexts. Business income statements as well as tax forms depend on starting with total revenue and subtracting expenses and deductions. In a similar manner, MNEs would be taxed on their total sales but credited with sales that they showed were made outside the United States. That simple change in the calculation would negate almost all the concerns expressed by those scrutinizing SFA.

However, if the product was changed significantly, it should be considered a sale outside the United States, and profit from that sale would not be taxed. For example, if Malden Mills Industries in Massachusetts sells its Polartec fleece to Bosung

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16Daniel N. Shaviro, “Rethinking Foreign Tax Creditability,” 63 Nat’1 Tax J. 709-722 (2010). See also Donald L. Barlett and James B. Steele, America: Who Really Pays the Taxes? 183-189 (1994). One of the underreported stories is how first the oil companies and then all resource companies finagled royalty payments into income taxes so they could be credited against U.S. tax liability. The substitution of income taxes for what otherwise would be royalties or extraction taxes has denied the United States its share of taxes on the income of resource companies, particularly petroleum companies.

17Again and again experts bring up an Irish distributor that sells Apple products into the United States with a very low markup. This is not a valid objection, because this is not how Apple handles international business. Three randomly chosen distribution agreements each specify the countries that the distributor is authorized to sell to as well as those that are forbidden. Therefore, Apple will never allow a low-margin distributor in Ireland or elsewhere to sell outside its territory.

Legislation should be drafted to clearly prohibit sales to U.S. customers by distributors outside the United States, and it could provide a safe harbor for distributor agreements that spell out that restriction. Congress would just need to include in the legislation wording that would require companies to take some simple steps to ensure that products sold outside the United States remain outside the United States. I believe that using the subtraction method for SFA solves many problems. As Reuven S. Avi-Yonah says, “All imports fully taxed and all exports fully excluded.” Simple. And that makes SFA essentially a border-adjustable tax, which has many international trade advantages.
Engineering Co. Ltd. in Korea, which in turn produces jackets for The North Face Inc. in the United States, the jackets will come into the United States with an entirely different International Harmonized Tariff System (HTS) code than was used for the fabric exported to Korea. Malden Mills would therefore count the Bosung sale as a non-U.S. sale and would not pay corporate tax on the apportioned income from that sale. It may be that Polartec comes under HTS code 6001.22.000, and The North Face jacket might be imported under HTS code 6110.30.3040. Legislation would need to specify the level of difference required to qualify an intermediate sale as “outside the United States” when the final product is imported into the United States.

One valid objection is that a company could purchase a low-profit, high-volume foreign company, which could dilute its profits in a sales-based system. But purchasing low-profit, high-sales companies is not for the faint of heart. Those low profits are generally the result of intense competition, and the line between profit and loss can be very thin. Legislation requiring a minimum gross margin, such as 15 percent, might be necessary to make it more difficult for a multinational to purchase a low-profit, high-volume company for the tax advantages. There is also the possibility that the stock market would punish such a diverse company.

Permanent Establishment

Permanent establishment requirements may present another stumbling block to implementing SFA. Though first conceived over a century ago, PE is increasingly irrelevant in the digital age. For instance, a foreign MNE could establish a sales office in Windsor, Ontario, and cross the international Peace Bridge daily to sell to American automakers in Detroit without creating a PE. One can therefore imagine revenue of $1 billion without the establishment of a PE in the United States. New York considers the PE requirement satisfied for any company with $1 million in New York sales. Professor Reuven Avi-Yonah and others have advocated that the threshold for PE should be revenue based.18

State Benefits

Another factor to consider is that states have been unable to appropriately tax MNEs because of water’s-edge legislation. This legislation was forcefully advocated by the Reagan administration in the 1980s. SFA would provide substantial additional state revenues without raising rates. It would be unnecessary to change the water’s-edge exclusion because SFA would deem the increased taxable income domestic.

SFA Benefits

SFA has many appealing qualities, not the least of which is that it is territorial. But it is much more than that. Companies will go to any lengths to increase sales and reduce expenses. Although they are expenses, payroll and property are highly desired by states and countries, and even though they are highly valued by the taxing authority, companies will minimize these expenses, particularly if taxed. Because companies so highly value sales, taxing sales is least likely to change company decisions in ways that distort the economy. Additional SFA revenues would come from current tax-avoiding MNEs, and that additional raised revenue could be used for infrastructure projects or debt and deficit reduction. In other words, the elimination of tax expenditures and the elimination or reduction of the interest deduction could go entirely to rate reduction and increased graduation. However, any added revenues from multinationals, both foreign and domestic, that are not a result of the elimination of tax expenditures and the elimination or reduction of the interest deduction might be used to fund infrastructure projects or reduce the deficit and debt.

Because SFA treats all companies, domestic and international, the same, there would be no competitive disadvantage or advantage in international markets for the United States having a significantly different corporate tax rate than the rest of the world. And because profits from exports are not taxable, there would be a substantial incentive for domestic companies to emphasize foreign markets and sales.

Companies that now receive large tax expenditure reductions in pretax income would oppose this change. That would be particularly true for inverted companies because there would no longer be any advantage to their inversions. However, other companies that have been paying close to the “rack” rate would benefit. The tension between these two groups might give the SFA proposal a chance. And because SMEs would receive the most benefit, there should be substantial support for the change. The old countervailing power dynamic could be used to help get an agreement. As Christine Lagarde, managing director of the IMF, said, “There would be more revenue for all if countries resisted the temptation to compete with each other on taxes to attract business. By definition a race to the bottom leaves everybody at the bottom.” SFA would allow the United States to sidestep that race.

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18 Further research will be needed to establish the appropriate threshold for a PE, but it almost certainly would be between $1 million and $10 million.
Conclusion

This proposal not only meets Apple’s requirements but provides additional economic benefits as well. And it would seemingly meet Ryan’s need for tax relief to grow the economy while also meeting many of Nunes’s requirements. Although the proposal could be revenue positive, the added revenue would be derived from companies that currently are not paying their fair share of taxes. Starting with book income helps remove the government from business decisions and provides additional revenues that can be channeled to reduce corporate income rates. Reducing or eliminating the interest deduction would strengthen our economy and help to further lower corporate tax rates. Graduating taxes encourages SME growth and discourages mega-mergers. SFA treats all businesses the same and provides a tamper-proof territorial system that is by far the strongest of the proposals suggested for fixing the undisputedly broken corporate tax system. It is territorial, would avoid all or most of the ways that companies use to game our current system, and would provide much-needed revenue to states while raising more revenue at lower rates.

IN THE WORKS

A look ahead to planned commentary and analysis.

IBM — the prequel: The MTC election and the single business tax (State Tax Notes)

Lynn Gandhi examines the Michigan Court of Appeals’ recent finding that the state’s Single Business Tax Act did not implicitly repeal the election of the Multistate Tax Compact by taxpayers and that the state’s Public Act 282 of 2014 did not bar taxpayers from refund claims.

A brief review of corporate tax articles of 2014-2015 (Tax Notes)

Jordan M. Barry and Karen C. Burke review notable corporate tax law literature from 2014 and 2015, including an article on whether corporations should have to publicly disclose their returns in light of recent aggressive international corporate tax minimization strategies and the theory that public shaming could affect corporate behavior.

Significant issue rulings leave lots to the imagination (Tax Notes)

Jasper L. Cummings, Jr., analyzes two letter rulings on spinoffs and is critical of one that involves the continuity of business enterprise requirement.

Taxpayer rights: Coping with globalization and uncertainty (Tax Notes International)

Duncan Bentley redefines the terminology of taxpayer rights, explores the concept of pragmatic rights founded in soft law, and shows that when the principles and legal rules that form the basis for protecting taxpayer rights are reinforced by a strong rule of law, rights expand through taxpayer engagement.

A catalog of confusion — VAT repayments (Tax Notes International)

Trevor Johnson discusses a long-running and complex appeal, involving four companies and several different VAT repayments, heard by the U.K. Supreme Court.
The Earned Income Tax Credit: Trust, but Verify

By J. Kent Poff

Abstract

The earned income tax credit program is criticized because of overpayments that come from fraud and abuse of the program. This article shows that the IRS contributes to the problem because in some circumstances, a taxpayer that follows IRS rules receives a substantially larger credit than the law allows.

In an example taken from an actual return, a taxpayer follows IRS rules and receives a credit that is $2,450 larger than allowed by law. The overpayment of the credit results from tables prepared by the IRS that do not properly reflect phaseout of the credit as income increases. The improper phaseout occurs when the taxpayer has earned income that is less than the maximum allowed for the credit but has enough other income to cause the credit to phase out. Fortunately, that does not occur frequently.

Introduction

The EITC has been criticized politically, often by Republicans, because of fraud.1 Consistent with those criticisms, President Obama ordered a study because of suspected improper payments and waste in the EITC and other programs.2

Responding to the executive order, the Treasury Inspector General for Tax Administration published a report stating that the “IRS has made little improvement in reducing improper Earned Income Tax Credit payments since being required to report estimates of these payments to Congress.”3 In fact, the report estimates that approximately 22.8 percent of EITC payments totaling approximately $12.6 billion were improperly paid.4 Those estimates suggest that EITC payments total approximately $55 billion annually. A major source of improper payments of the EITC program is the IRS itself.

Calculation of the Credit

The EITC is designed to give low-income taxpayers an incentive to work. The basic EITC is calculated by multiplying the taxpayer’s earned income5 (up to a maximum amount) by the earned income percentage.6 However, the basic EITC is phased out when adjusted gross income is above a minimum amount.7 That phaseout depends on marital status and number of children in the household. For example:

Example 1: Suppose that a taxpayer is single, has two qualifying children, and has earned income and AGI of $31,125. In this case, the maximum earned income available for the credit is $40, percent of $13,870. However, the credit is phased out at 21.06 percent of the excess of the AGI over the phaseout limitation of $18,110.8 The results are as follows:

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4Between 21 and 24.6 percent (22.8 percent point estimate) of the EITC payments totaling between $11.6 and $13.6 billion ($12.6 billion point estimate) were paid improperly (TIGTA report, supra note 3, at 27).

5Earned income is taxable employee compensation and self-employment income. Section 32(c)(2)(A).

6Section 32(a)(1).

7Section 32(a)(2).

From the earned income credit worksheet A (Appendix A) and the EITC table (Appendix C), the earned income credit in Example 1 is calculated correctly in the tables and is $2,807.

Example 2: Suppose the same facts as in Example 1, except that the taxpayer has earned income of $6,125, while still having AGI of $31,125. Therefore:

<table>
<thead>
<tr>
<th>Basic credit:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum income subject to the credit</td>
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<tr>
<td>Credit percentage</td>
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<tr>
<td>Basic credit</td>
</tr>
<tr>
<td>Phase out of the credit:</td>
</tr>
<tr>
<td>Greater of earned or adjusted gross income</td>
</tr>
<tr>
<td>Phase out starts</td>
</tr>
<tr>
<td>Excess of income over phase out</td>
</tr>
<tr>
<td>Credit percentage</td>
</tr>
<tr>
<td>Phase out</td>
</tr>
<tr>
<td>Net earned income credit:</td>
</tr>
</tbody>
</table>

From the earned income credit worksheet A (Appendix B) and the EITC table (Appendix C), the earned income credit in Example 2 is $2,450, which is incorrect. As seen in the calculation above, IRS tables do not take into account that the taxpayer did not have the maximum earned income before the phaseout starts. That is inconsistent with section 32(a)(1), which requires that the credit on income actually earned — not the credit on the maximum income that might be earned — be reduced by the phaseout.

Summary, Conclusion, and Recommendations

The EITC program assists low-income taxpayers, but it is criticized because it is subject to fraud and abuse. The president issued an executive order to reduce improper payments and waste in federal programs, including the EITC program. The IRS has been criticized by TIGTA for inadequately complying with the president’s executive order.

In addition to inadequately reducing improper EITC payments, the IRS contributes to the problem by publishing tables that give a larger credit than allowed by the law. The credit overpayment occurs because the published tables do not properly reflect phaseout of the credit as income increases. The improper phaseout occurs when the taxpayer has earned income that is less than the maximum allowed for the credit but has other income that is enough to cause a phaseout of the credit.

This article has shown the correct credit calculations. Therefore, the IRS should comply with the law, reduce improper payments of the EITC, and increase compliance with the president’s executive order by developing tables that use the correct formulas to compute the credit.

(Appendices appear on the following pages.)
Worksheet A - 2015 EIC

**Part 1**

1. Enter your earned income from Step 5.  
   - 1 31,125

**All Filers Using Worksheet A**

2. Look up the amount on line 1 above in the EIC Table (right after Worksheet B) to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
   - 2 2,807

   If line 2 is zero, STOP. You cannot take the credit.
   
   Enter "No" on the dotted line next to line 66A

3. Enter the amount from Form 1040, line 38  
   - 3 31,125

4. Are the amounts on line 3 and 1 the same?
   - X YES. Skip line 5; enter the amount from line 2 on line 6.
   - NO. Go to line 5.

**Part 2**

5. If you have:
   
   a. No qualifying children, is the amount on line 3 less than $8,250 ($13,750 if married filing jointly)?
   
   b. 1 or more qualifying children, is the amount on line 3 less than $18,150 ($23,650 if married filing jointly)?

   YES. Leave line 5 blank; enter the amount from line 2 on line 6.
   
   NO. Look up the amount on line 3 in the EIC Table to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
   
   Look at the amounts on lines 5 and 2. Then, enter the smaller amount on line 6.

**Part 3**

6. This is your earned income credit  
   - 5 2,807
**Appendix B**

**Worksheet A - 2015 EIC**

### Part 1

1. Enter your earned income from Step 5.
   - 1  6,125

### All Filers Using Worksheet A

2. Look up the amount on line 1 above in the EIC Table (right after Worksheet B) to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
   - 2  2,450

   If line 2 is zero, STOP. You cannot take the credit.
   Enter "No" on the dotted line next to line 66A

3. Enter the amount from Form 1040, line 38
   - 3  31,125

4. Are the amounts on line 3 and 1 the same?
   - X NO. Go to line 5.

### Part 2

5. If you have:
   - a. No qualifying children, is the amount on line 3 less than $8,250 ($13,750 if married filing jointly)?
   - b. 1 or more qualifying children, is the amount on line 3 less than $18,150 ($23,650 if married filing jointly)?

   - X NO. Look up the amount on line 3 in the EIC Table to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
     - 5  2,807
     - Look at the amounts on lines 5 and 2.
     - Then, enter the smaller amount on line 6.

### Part 3

6. This is your earned income credit
   - 5  2,450

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For more Tax Notes content, please visit [www.taxnotes.com](http://www.taxnotes.com).
## Appendix C. Earned Income Credit Table

<table>
<thead>
<tr>
<th>Earned Income</th>
<th>Single, Head of Household, Widow(er)</th>
<th>Married, Filing Jointly</th>
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<td>$5,900-5,925</td>
<td>$453</td>
<td>$2,015</td>
</tr>
<tr>
<td>$5,950-5,975</td>
<td>$457</td>
<td>$2,032</td>
</tr>
<tr>
<td>$6,000-6,025</td>
<td>$461</td>
<td>$2,049</td>
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</table>
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(Especially when someone else is counting on yours.)

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Million-Dollar Dirt: A Look at the IRS Whistleblower Program

By John Myrick

John Myrick is a legal editor with Tax Notes. His column takes a second look at some of the more unique, provocative, and noteworthy stories covered by Tax Analysts reporters.

In this column, Myrick examines the IRS policy of paying informants to betray the tax secrets of their employers and colleagues.

A. Little Socrates the Arsonist

The law of the playground is taught by morally questionable figures. The same person who teaches you not to tattle is usually also the one who tells you that crayons are edible or that it’s a good idea to stick peanuts up your nose. And he’s probably the one who benefits most from your silence. Nevertheless, these lessons — particularly the rule on tattling — burrow deep into our system of ethics. But at some point they’re worth reconsidering and perhaps amending for the next generation: If your playground companion is a budding sociopath who likes to set things on fire, maybe it’s better to tell the teacher he found a box of matches, even if it costs you a friendship.

This strong resistance to tattling, whatever its origin, plays a role in the discussion of whistleblowers in the workplace. In a 1998 debate on whether the IRS should pay informants for leads on tax enforcement, Sen. Harry Reid, D-Nev., described the IRS program at the time as the “Award for Rats Program” and the “Snitch Program.”1 Reid did not prevail; the IRS program was not eliminated and in fact was substantially expanded in 2006 to further encourage tax whistleblowers to come forward. Not long after those statutory changes took effect, Bradley Birkenfeld blew the whistle on the tax evasion practices of Swiss bank UBS AG,2 which resulted in a $780 million settlement and kick-started further efforts that have led to billions more collected from other Swiss banks and their U.S. taxpayer clients.3

But to those who strictly adhere to the no-tattling rule, maybe the results don’t justify the means. After all, Birkenfeld got a nice payday for his dirt: $104 million. And he was not entirely squeaky clean himself. He had worked for UBS to help clients hide assets and evade taxes and once smuggled funds for a client by stuffing diamonds into a tube of toothpaste.4

Ultimately, to accept the idea of a whistleblower program, you have to be OK with giving taxpayers a financial incentive to rat on their co-workers and with the government paying potentially bad actors for good information. If that doesn’t bother you, you’ll like that the whistleblower program has been one of the IRS’s most cost-effective sources of recovering unpaid taxes.

But if you don’t like the program, there’s good news for you, too — its shortcomings have been heavily criticized by both government officials and practitioners. Recent reports by the Government Accountability Office5 and the Taxpayer Advocate Service (TAS)6 reveal that the IRS program moves too slowly, leaves whistleblowers in the dark on the status of their claims, and pays awards in only a tiny percentage of cases. Some major critics, such as Senate Finance Committee member Chuck Grassley, R-Iowa, argue that this reluctance to embrace whistleblowers reflects the IRS Office of Chief Counsel’s disdain for the program.7

Department press release, “UBS Enters Into Deferred Prosecution Agreement” (Feb. 18, 2009).


B. Value by the Numbers

The IRS is missing out on potentially billions in revenue by failing to take full advantage of the whistleblower program, according to Dean Zerbe of Zerbe, Fingeret, Frank & Jadav PC, interviewed by Andrew Velarde in a December 2015 story for Tax Notes. “Bang for buck for honest taxpayers — it’s hard to beat a program that is bringing in $6 from big-time tax cheats for every $1 it pays in awards,” he said.8

A 1999 study found that the use of whistleblower information had a better cost-benefit ratio and a lower no-change rate than other IRS enforcement methods. For every dollar collected from the informant in audits of 1996–1998 returns, the IRS “incurred slightly over four cents in cost (including personnel and administrative costs),” compared with a cost of over 10 cents per dollar collected through other programs.9 At its best, the whistleblower program should provide the IRS with direct information on tax fraud and put good, usable evidence in the hands of agents. Compare this with the IRS’s other primary tool for discovering fraud: a statistical method called the discriminant index function, which scores income tax returns based on their likelihood of error and potential profitability and leaves auditors with the task of finding the smoking gun.

There is a lot of money to be made by improving enforcement. The net tax gap — the amount that taxpayers owed but did not voluntarily and timely pay — was estimated to be $385 billion for 2006, the most recent year for which this estimate is available.10

And the IRS’s resources available for enforcement have been shrinking. Congress has cut back on the IRS’s budget in recent years, which has cost the IRS enforcement personnel, and the agency expects to lose another 2,000 to 3,000 employees overall in 2016.11 Given the decline in resources, it should be a nice treat for the IRS when it can forgo the task of finding the smoking gun.

Recognizing the value of the program, Congress overhauled it in 2006 to improve the award determination process.12 Before then, payments to whistleblowers were largely discretionary, ranging from 1 percent to 15 percent of proceeds collected, and whistleblowers had little ability to challenge IRS decisions. The program — which had been in operation since 1867 — was not advertised, and IRS employees were told not to encourage taxpayers to provide information in exchange for awards.13 The 2006 act was meant to remedy those perceived problems. It established the IRS Whistleblower Office (WO) and, for claims involving amounts in dispute in excess of $2 million,14 allows whistleblowers to appeal IRS determinations to the Tax Court and mandates in most cases a minimum payment of 15 percent of collected proceeds (but no more than 30 percent).15

C. What Could Possibly Go Wrong?

1. A glut of frivolous claims. Tax Analysts Deputy Publisher David Brunori brings up an interesting point in explaining why he dislikes whistleblower programs: He argues that financial incentives to report tax fraud tend to generate frivolous claims against businesses thought to have deep pockets.16

The experience with whistleblower law at the state level has shown this to be a real problem. Some states go beyond what the IRS program offers and allow whistleblowers to bring lawsuits on their own under qui tam statutes, with or without the intervention of the government. In the federal program, by contrast, whistleblowers must present their claims to the IRS, which then decides whether to proceed with an audit.

If there is a symbol of the excesses that can occur under a do-it-yourself regime, it’s probably Stephen B. Diamond of Chicago, who as of January 5, 2016, had filed 938 qui tam tax actions. As discussed by Amy Hamilton in State Tax Notes, Diamond’s basic strategy is “to purchase products from out-of-state businesses over the Internet and file qui tam actions alleging fraud when companies fail to collect use or liquor excise taxes on the purchases or on a portion of the shipping and handling charges.”17 These pirate whistleblowers can use (abuse?) the law to jump on a small mistake, sue a business to get access to its books and records, and then hope to hit

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9 TAS, supra note 6, at 145, discussing IRS, ‘“The Informants’ Project: A Study of the Present Law Reward Program” (Sept. 1999).
10 GAO, supra note 5, at 2.
13 Kwon, supra note 1, at 452-453.
14 Also, if the taxpayer reported on is an individual, for the 2006 act protections to apply, his gross income must exceed $200,000 for any tax year subject to the action.
15 GAO, supra note 5, at 24; section 7623(b). Factors can reduce the minimum 15 percent payment in some cases, such as when the information provided by the informant was already publicly disclosed.
16 Brunori, “Qui Tam and a Nation of Rats,” State Tax Notes, Oct. 12, 2015, p. 147.
the jackpot. And the taxpayers who must defend themselves in these lawsuits do so without the normal rights they would have in audits before the Illinois Department of Revenue.

Because of the explosion of these “vigilante tax administration” lawsuits, the Illinois DOR is hesitant to issue voluntary compliance bulletins — which help notify businesses of potential areas of concern so they can return to compliance — because of the “fear that they will provide a roadmap to those who seize on areas where the law may not be clear to file for [qui tam tax] actions,” Illinois Revenue Director Connie Beard said.

There is some evidence that the IRS is similarly awash in a sea of frivolous information. Of all the claims closed in fiscal 2014, the IRS paid an award on only 3.65 percent.18 In fiscal 2015 that number fell to 1.9 percent.19 But these low percentages could also be the result of other factors, discussed below, such as not having enough manpower or adequate processes to efficiently evaluate all claims.

The argument in favor of qui tam lawsuits is that they overcome the problem of limited resources or lack of government interest. If the government will not pursue a legitimate case, for whatever reason, whistleblowers can take it to the courts and achieve some justice on society’s behalf. Some types of cases would be off limits, of course (namely, those requiring sophisticated legal or economic analysis), but, the argument goes, whistleblowers could handle straightforward cases of fraud.

And qui tam regimes might avoid the Illinois problem by setting the right limits on claims. The New York statute, for example, allows qui tam actions only against businesses that net more than $1 million annually and knowingly defraud the government of more than $350,000 in taxes.20 The current flag bearer for the success of that state’s regime is the ongoing litigation against Sprint Nextel Corp., in which the company is alleged to have knowingly avoided about $130 million of sales tax obligations.21 Unfortunately for Sprint, under the New York whistleblower act, those guilty of tax fraud must pay triple the amount of tax owed, plus penalties and interest, which increases the amount at issue to almost $400 million. This could result in a nice check for the whistleblower, who will receive up to 25 percent of any revenue the state collects based on the information he provided.

2. Clogs in the federal pipeline. According to the IRS, of the claims it closed in fiscal 2014, 39.6 percent did not involve a “tax issue,” 7.9 percent contained unclear or nonspecific allegations, 4.2 percent involved information the IRS already knew, and 4.5 percent weren’t worth developing because the statute of limitations had already expired.22 About 1.2 percent of cases were closed explicitly because the IRS lacked the resources to pursue them.23

But clearly some claims have substance. The IRS collected about $501 million in fiscal 2015 based on the information whistleblowers provided, paying approximately $103 million in rewards (around 20.6 percent of the amount collected).24 The GAO report suggests that time pressures and inefficient processes sharply reduce what the IRS might be able to recover:

WO staff told us that in some cases it was obvious in the mail processing administrative review that some submitted claims were not worthy of pursuit, but such claims are moved along to ensure all claims receive a fair and honest consideration. They told us that these claims came in with only vague insinuations of wrongdoing and that a small number of whistleblowers submit multiple claims of this type per month. . . However, the process is not set up to allow the [Initial Claim Evaluation (ICE)] unit to deny such claims. As a result, the ICE unit ends up performing administrative functions on claims that are likely to be denied [later]. The result is added costs

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1 IRS WO, “Fiscal Year 2014 Report to the Congress,” at 16 (July 2015). Of 6,520 claims closed in fiscal 2014, awards were paid on 238, about 3.65 percent.
5 Hamilton, supra note 18, at 16. The IRS used two categories for claims denied because of expired statutes of limitations; I combined the numbers to calculate the figure of approximately 4.5 percent.
6 The IRS WO fiscal 2015 report combines several of the categories used in the 2014 report. The overall numbers appear similar, except that in 2014, 24.8 percent of claims are described as “closed — other.” The WO noted in the 2015 report that it provided additional training to reduce the number of claims that fall into this miscellaneous category. However, the numbers in the “other” category do not appear on their own in the 2015 report but are combined with claims from two other 2014 categories: “information already known” and “lack of IRS resources.”
7 IRS WO, supra note 19, at 11. $103 million represents the amount that would have been paid if not for sequestration, which reduced the actual award payments by $7.5 million.
and time to the overall review process because claims known to be of poor quality are allowed to advance.  

By spending too much time on clear losers, the IRS could be missing deeper evaluation of the cases that do have merit. And there is already too little time to evaluate claims: As of the publication of the GAO report in October 2015, the WO had a backlog of over 11,000 cases.  

Some whistleblowers, after their claims were denied, have taken their cases to the Tax Court. The court has been receptive, establishing that it has jurisdiction over denial determinations, but it cannot force the IRS to undertake audits that the agency would not otherwise pursue. And if the IRS does not collect proceeds in a case, the whistleblower has no claim for payment, no matter how good the information might have been.  

D. The High Cost for Whistleblowers  

The TAS report discusses a study of 64 whistleblowers in which the authors found that a “significant percentage of whistleblowers remain out of work or underemployed, bitter about their punishment, and uncertain of ever being able to restore their lives fully.”  

Even though Birkenfeld hit the jackpot with a $104 million payday, most whistleblowers face a starkly different reality. Of the lucky few who do get paid, most generally receive nothing until years after they submit their initial claims. In the meantime, they have little contact with the IRS regarding their cases and zero legal protection under the tax code for retaliatory actions their employers may take.  

1. Slow is too fast a word. The IRS, understandably, doesn’t pay whistleblowers upfront. Before a whistleblower can get an award, the IRS must accept the case, successfully recover from the taxpayer, and then wait for all rights regarding potential appeals and requests for refunds to be exhausted. Then the WO must decide on an award amount, which takes a surprisingly long time — 18 to 54 months, according to the GAO, slightly longer than the IRS target completion time of less than 90 days.  

As shown in the chart below, agents from the WO begin and end the process, accepting claims and determining award payments, but agents from other operating divisions decide whether to act on the information. For claims paid in 2015, whistleblowers had to wait on average six to nine years to receive an award following the submission of a claim.  

2. The veil of secrecy. One of the biggest complaints about the program is how little communication the IRS has with a whistleblower once a case is underway, particularly once it has reached the field office for audit. This can be frustrating for whistleblowers and also costs the IRS the opportunity to use the whistleblowers’ inside knowledge to further develop cases.  

There are important reasons why communication is limited, however. Namely, the tax code forbids IRS employees from disclosing confidential information, a rule they could violate by discussing cases with whistleblowers. The prohibition is pretty broad, even preventing the IRS from disclosing whether the whistleblower’s information led to an audit or, if not, why.  

Various fines and penalties are associated with releasing confidential information, and they do have some teeth: In 2013, former IRS employee Dennis Lerner faced up to 10 years in prison for disclosing the identity of a whistleblower. He ultimately accepted a plea deal and received three years’ probation and a $10,000 fine. (The facts of the case don’t inspire a lot of confidence in the whistleblower process: Lerner expressed his frustration with his IRS co-workers in an email, saying he “work[s] with fools” and got “paid next to nothing” for it. According to the charges against him, his disclosure was made to an executive of the bank the whistleblower reported on. And less than a year after revealing the whistleblower’s identity, Lerner accepted a job with the bank.)  

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25GAO, supra note 5, at 19.  
26Id. at 17.  
28See, e.g., Whistleblower One 10683-13W v. Commissioner, 145 T.C. No. 8 (2015) (“We agree with petitioners that their entitlement to an award turns on two issues: first, whether there was a collection of proceeds, and, second, whether that collection was attributable in some way to the information that petitioners provided.”).  
29TAS, supra note 6, at 412.  
30GAO, supra note 5, at 15. These data are based on 17 cases the GAO examined that closed in 2015.  
32Section 6103; TAS, supra note 6, at 146.  
33Eric Kroh, “Former IRS Employee Pleads Guilty to Disclosing Information,” Tax Notes, Mar. 18, 2013, p. 1311.  
34Justice Department press release, “Former IRS Official Sentenced in Manhattan Federal Court for Violating Conflict of Interest and Audit Disclosure Laws” (July 16, 2013).  
There is a solution for the confidentiality restrictions in the tax code, however. Section 6103(n) gives the IRS the authority to enter into agreements with whistleblowers to disclose returns and return information to the extent necessary for purposes of tax administration. These agreements allow the IRS to discuss cases with whistleblowers and require whistleblowers to keep all disclosed information confidential.36

Despite releasing memos in 2012 and 2014 expressing its interest in using these agreements, the

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36Reg. section 301.6103(n)-2(c).
IRS has never entered into one with a whistleblower.37

The IRS is not completely opposed to those agreements, however. Although the agency is not required to report the number of disclosures it has made under section 6103(n) specifically, it said in 2012 that it has made more than 8 billion disclosures of tax returns and return information under section 6103 generally, although they were primarily made to other government agencies.38 One high-profile example of a section 6103(n) contract is the one the IRS entered into with Quinn Emanuel Urquhart & Sullivan LLP in May 2014 so the law firm could “assist with the evaluation, analysis, presentation and defense of claims or adjustments related to the issues under examination” in the transfer pricing case against Microsoft Corp.39 (The agreement with Quinn Emanuel has raised some strong objections regarding the high fee the IRS paid for the firm’s services in the audit phase of the case, around $2.2 million,40 but the fee pales in comparison with what the IRS has paid to some whistleblowers.)

To its credit, the IRS has used other, more limited disclosure exceptions under section 6103 to communicate with whistleblowers.41 As Velarde reports, however, the IRS could take any of a number of steps to expand this communication without violating the existing statutory regime; it just chooses not to.

In fact, the IRS’s most recent undertaking in this area was to reduce communication with whistleblowers, not increase it. In March 2015 it launched a pilot project to test the effect of sending letters to eligible whistleblowers each year simply to let them know that their cases are still open.42

This is not new information — whistleblowers could already call the IRS to ask about the status of their cases. The point of the pilot is to preempt whistleblowers from doing so. What’s interesting is that the IRS has said it will not verify the success of this program by calling participants and asking them whether they found the letters helpful. The rationale is that speaking with taxpayers about the program would undermine the effort to reduce the volume of phone calls. However, the IRS did say it would monitor press coverage and Internet message board discussions.43

3. Old technology and ill-delivered mail. Compounding the silence with whistleblowers is the fact that the IRS has had a difficult time keeping up with where to find them. The IRS does not automatically update whistleblowers’ addresses when they report new ones on their personal returns. To make an address change, a whistleblower must separately contact theWO with the information; even then, the WO has said that updating addresses can be a "challenging and time-consuming" process.44 And when cases drag out over seven years, the likelihood a whistleblower will change mailing addresses a time or two is pretty high.

The result has been that letters have been sent to the wrong places. Whistleblowers, for good reason, are protective of their secrecy, so this can be a big problem. Making matters worse, on at least one occasion, the IRS identified itself in the return address as "IRS Whistleblower Office," which one hopes went unnoticed by any of the whistleblower’s co-workers who may have seen the envelope.

Why is updating addresses so difficult? The computer software the WO uses to store case information, E-TRAK, was not designed for how it is being used, and it sounds like a pain to deal with. The GAO report indicates that for some purposes, the WO forgoes using E-TRAK and just keeps the information in separate spreadsheets — even though the data is not tied to E-TRAK and must be manually entered and updated.

To update a whistleblower’s address in the system, an IRS agent can’t simply enter a new one in the whistleblower’s E-TRAK profile. The agent has to individually update every file associated with the whistleblower’s name, a process that most of us would justifiably describe as “challenging and time-consuming.”45

4. Hyper-technical arguments. The IRS has been criticized for aggressively seeking to minimize payments to whistleblowers and step around the generous award provisions of the tax code. Grassley described his feelings on the situation in a question to IRS Commissioner John Koskinen:

I again find myself frustrated with an IRS Chief Counsel office that seems to wake up every day seeking ways to undermine the whistleblower program both in the courts and


40Ryan Finley, “The IRS Doesn’t Need Outside Law Firms, Observers Say” (Nov. 4, 2015).


43GAO, supra note 5, at 37-38.

44Id. at 39-41.

45Id. at 41.
the awards. I am especially concerned that chief counsel is throwing every argument it can think of against whistleblowers in tax court. It appears at times that the Chief Counsel’s office thinks its job is to come up with hyper technical arguments and seek to deny awards to whistleblowers who have risked their lives to uncover big time tax cheats. I ask that your office and the director of the whistleblower office review the chief counsel’s wasteful and harmful litigation positions that undermine the whistleblower program and go directly against your support for the whistleblower program.  

When awards are challenged in the Tax Court, the court has often sided with whistleblowers, taking an expansive interpretation of its jurisdiction and the information available in discovery. In a recent case, for example, the IRS denied an award, even though the whistleblowers claimed to have provided information leading to more than $70 million of tax adjustments from an offending corporation. The IRS argued, however, that it could not confirm or deny the amount of the adjustments because it was outside the “administrative record.” In a somewhat incredulous tone, the Tax Court ordered the IRS to comply with the request for information:

How could evidence related to whether there was a collection of proceeds and whether that collection was attributable to the whistleblower’s information not be part of any purported administrative record? Any such evidence goes to the very basic factual inquiries required by section 7623(b). Respondent’s lack of direct response to petitioners’ motions appears to indicate that the current “administrative record” is incomplete.  

5. No legal protection against retaliation. By the nature of their act, whistleblowers burn bridges with the people they report on — and sometimes those people strike back. Because of this, many major whistleblower laws include provisions to discourage or punish retaliation. For example, the federal False Claims Act provides that whistleblower employees and contractors are entitled to all relief necessary to make them whole following discriminatory actions taken against them, including job reinstatement at the same seniority level, twice the amount of back pay owed, and compensation for special damages sustained as a result of the discrimination, including litigation costs and attorney fees.  

However, the act excludes tax whistleblowers from its statutory regime, and there are no corresponding rules in the tax code protecting whistleblowers.  

The retaliation threat is not hypothetical. Tax whistleblowers take a major risk by passing information to the government, particularly when the stakes are high and the people involved have already shown a willingness to break the law. A 2014 Tax Court opinion discusses the dangers faced by a whistleblower who reported on a group that the government described as “linked to violent events and terrorist organizations” and which, as alleged by the whistleblower, had murdered a person who previously spoke up about the group’s activities. When the whistleblower initially raised the concerns about tax fraud to his employer, he was fired, and the employer used “physical force and armed men to intimidate the whistleblower and prevent disclosure.” According to the opinion:

The whistleblower received a death threat from the targets, communicated through their counsel. After learning of the individuals and entities involved, the Government offered to place the whistleblower in the witness protection program. The whistleblower declined placement in the witness protection program, but requested and was granted confidential informant status. The whistleblower was also forced to hire counterterrorism experts to advise the whistleblower’s family on safety and protect the whistleblower on trips abroad. This protection cost the whistleblower tens of thousands of dollars.  

In extreme cases like this one, no further legal protections should be necessary to discourage physical violence or murder, but Congress should add protections against the loss of one’s livelihood and reputation. This would be an easy (and seemingly noncontroversial) fix for Congress. The new provisions could simply be patterned after those in the False Claims Act or any number of other laws that work to the same effect.  

In February, Lee Martin, who took over as WO director in August 2015, called for Congress to pass  

46“Questions for the Record” (including Koskinen’s responses to follow-up questions to a Feb. 3, 2015, Finance Committee hearing on IRS operations and the president’s fiscal 2016 budget).

47Whistleblower One 10683-13W, 145 T.C. No. 8.

4831 U.S.C. section 3730(h); TAS, supra note 6, at 411.

49Whistleblower 11332-13W v. Commissioner, T.C. Memo. 2014-92, at *4 (granting the whistleblower’s motions to seal the record and proceed anonymously).
this type of protection for whistleblowers.\textsuperscript{50} According to the recent WO report, anti-retaliation measures for whistleblowers have been among the Obama administration’s budget proposals since fiscal 2014.\textsuperscript{51}

E. Conclusion

Whistleblowers may have to betray an expectation of trust and loyalty to share their information, and some may have been complicit to a degree in the bad actions, but from an enforcement perspective, their contributions are cost effective and highly valuable.

Interestingly enough, the IRS in 2015 had to deal with a whistleblower of its own, William Henck, who exposed what he called the “secret law” of the IRS, in which a few senior officials would make decisions for the agency based on personal or unknown reasons and sometimes in disregard of the tax code. He described it as follows:

The decision-making process for a particular case or type of case is corrupted or compromised by high-level executives basically on a whim or fiat or in an arbitrary fashion. . . . If they inquire, agents and attorneys are told that the matter was “vetted” at the highest level and that is that. . . . In every case where I have seen this happen, it has benefited well-connected taxpayers. I have never seen this type of corrupted or compromised decision-making benefit the public fisc. Basically, this is a white-collar version of a smash-and-grab robbery.\textsuperscript{52}

Henck said that as a result of his disclosures, he faced an investigation by the Treasury Inspector General for Tax Administration and could wind up getting suspended or fired.\textsuperscript{53}

Whether you love or hate whistleblowers, Congress has opened the IRS’s doors to hear them, and although IRS procedure is far from streamlined and may be operating under a few “secret law” decisions contrary to congressional mandates, it produces some good results. The government isn’t perfect — and that shouldn’t be the expectation or demand — but improvement in its treatment of whistleblowers would seem to benefit both the government and the American public.

\textsuperscript{50}WO 2015 report, supra note 19, at 4.
\textsuperscript{51}Id. at 10.
\textsuperscript{53}Hoffman, “IRS Whistleblower Says He’s Being Investigated by TIGTA,” Tax Notes, Sept. 21, 2015, p. 1320.
In Memoriam: Ira Shepard

By Calvin H. Johnson

Ira Shepard, professor emeritus at University of Houston Law Center, died March 27 of renal failure, after a battle with cancer, at age 78. He graduated from the Bronx High School of Science, majored in math and competed on the math team at Harvard University, and became a member of Harvard Law Review at Harvard Law School.

The new chemo had produced total remission, with no perceptible cancer. I emailed him “To Life” (English for “L’Chaim”), and he said, “I will toast to that.” Then renal failure killed him, almost immediately. He knew. He was ready.

Ira is irreplaceable. For the past 25 years, he and Marty McMahon have provided the first cut on history by digesting current developments in tax for continuing legal education presentations all over the country. “Spin and Marty” (Does anyone else go back that far to the Disney TV series of the ‘50s?) would play off each other, with Marty playing the straight-man liberal and Ira the right-wing quip.1 I think I was the matchmaker. Florida Tax Review has in recent years published the annual outlines. I hope the full archives will be available online somewhere. Tax law is a sedimentary rock of old cases laid down and now hardened. When courts decided them, we did not yet know where they would fit into the grand framework — what part they built up and what they changed — but Ira and Marty helped us see.

Apart from his politics, Ira was an astute observer of tax current events. He could supply a meaning to separate the chaff and the germ as the news went by. He remembered the history. He loved a good story, as long as it led to a good quip. He was always a pleasure to talk to, provided that we kept on the topic of tax. Ira was the Bronx High School of Science kid, and I am the White Plains High School kid. Who would have thought that we would grow very fond of each other?

In the summer of 1970, he was assigned as the Paul, Weiss, Rifkind, Wharton & Garrison LLP New York associate to help orient incoming summer associates. We were a radical bunch back then, having successfully canceled finals across various law schools to protest the U.S. invasion of Cambodia, and my class was willing to play off prior success and shut down the world. (I was away from campus on an externship so only read about it from afar.) Ira was a former naval officer, and I had a Purple Heart from Vietnam at that point. He sat next to me at a long table, with me at the end. We started to talk about student unrest — I was undoubtedly in favor of it — and we were off. For years. He did no further orienting of anyone else that day.

The highlight of American Bar Association Tax Section meetings for me was talking to Ira in the courtesy lounge. Over time, Ira (and Marty) took up more of those days, and the official presentations took up less. Who cared about the panels when there was Ira? In the last meeting before his retirement, I didn’t make it to any presentation, and yet it was a wonderful meeting.

Ours has been a continual conversation since 1970, with a deep underlying affection. Alas, it was not cleaned up and resolved at his death. He left us way too quickly.

Earth, take this worthy man.
Happy April Fools’ Day
From Tax Notes

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IRS Future State Plans Take Unexpected, Fuzzy Twist

Details continue to emerge regarding the IRS's secretive plans for its “future state,” and the latest news happens to be some of the cutest. The agency has long said that it plans to increase the role technology will play in tax administration, and it announced April 1 that it will be distributing automated “Tax Buddies” to every household in America.

“I never thought I would say this, but the IRS bought the rights to Teddy Ruxpin,” said Gil Daniels of Tax Tacklers LLP. “The former owners had millions of those talking bears, unused since the ‘80s, and they were headed for the incinerator. It was a right-place, right-time kind of deal. The first words out of those bears' mouths should be, ‘Thank heavens for the IRS.’”

“It’s an incredible brand enhancer,” an IRS spokesperson said. “The Tax Buddy can answer tax-related questions, you can access a data screen by rubbing its belly, and we’ve programmed it with some excellent tax jokes. I think this could change the whole ballgame. I mean, it’s hard to hate the tax man when he’s also your best friend.”

Results from the pilot program indicate a tough road ahead, however. “The voice sounds a lot like Siri,” said Jill Anderson of The Taxtonics. “Is that legal? Can you just steal Apple’s technology? I find it works OK, but for some reason when I ask it about passive losses, it directs me to the nearest Outback Steakhouse.”

Abe Flowers of Tax-Ability said, “My Tax Buddy is great. I'm hoping for the best. He brings back memories, and he has a real smile factor that the IRS desperately needs.” Still, Flowers added, “He’s a tough cookie when it comes to deductions. I actually sent him back to the agency because I thought he was broken. Denied, denied, denied. He’s funny about it — he once asked me whether I was ‘fur real.’ But I need him to be a little less teddy bear friendly and a little more taxpayer friendly.”

Cathy Miller from Totally Tax was less enthusiastic: “It’s creepy. That’s all I can really say. It just stares at you with those dead little eyes and drones on and on about the Pease limitation. Every night before I go to sleep, that thing goes in a drawer, which I then lock. I’ve been thinking about moving to Canada, and maybe it’s finally time.”

According to the IRS, rollout will proceed on schedule, and taxpayers in most major cities should expect to see their Tax Buddy waiting on the doorstep no later than June 1.

Kansas Celebrity Given Statutory Maximum for ‘Leaver’ Account

In one of the first criminal prosecutions directed at a Swiss bank program non-prosecution agreement (NPA) disclosure, Dorothy Gale of Kansas was sentenced to the statutory maximum of five years in prison for tax evasion linked to an undeclared foreign account, the Justice Department announced April 1.

According to the announcement, Gale closed her Swiss account in 2013 and transferred the funds to an account in an Emerald City, Oz, bank under the name of a close friend, Albert C. Lion. The Justice Department Tax Division received the details of the transfer as part of the disclosures required under the Swiss bank program when Gale’s former bank entered into an NPA with the Justice Department in 2015. The Justice Department declined to name either bank.

The district court judge for the U.S. District Court for the District of Kansas sentenced Gale to 60 months, the statutory maximum Gale faced for her convictions under section 7201 and 31 U.S.C. section 5322(a). Gale sought a downward departure from the sentencing guidelines determination based on her long history of good works and charity, particularly in Oz. She attempted to compare her case favorably with that of Beanie Babies founder H. Ty Warner, whose sentence of probation was recently affirmed, in part due to a history of good works.

The sentencing judge rejected the comparison, noting that unlike Warner, Gale never tried to disclose her accounts and also moved her account out of Switzerland in an attempt to hide it. “Clicking your heels together and hoping the problem will go away as though waking up from a dream is no way to solve a financial disclosure problem,” the Justice Department said.

Gale’s attorney, S. Reginald Crow of Crow, Woods & Mann SÃ, an Oz-based law firm, said Gale plans to appeal her convictions — claiming that the evidence of willfulness is lacking — as well as her sentence.

Emily Baum of Frank & Baum LLP told Tax Analysts that the appeal of the conviction will be particularly challenging because of the timing of Gale’s account transfer. Being a so-called leaver is strong evidence of intentional violation of a known legal duty, the standard for willfulness in criminal tax, she said.
Candy Man Indicted for Failing To Pay Employment Taxes

The Justice Department announced April 1 the indictment and arrest of chocolate magnate William “Willy” Wonka on employment-tax-related charges.

According to the announcement and charging documents, the IRS became suspicious when the multibillion-dollar business reported one, and only one, employee every year since resuming operations. Wonka is now the third largest chocolate producer in the world.

Arthur Slugworth, a competing chocolate manufacturer, told Tax Analysts, “Chocolate industry automation has advanced rapidly since Mr. Wonka suspended his business operations, but not so far that a whole factory could be run by just one man; he obviously has other people working for him.”

The indictment contains six charges of failing to either collect or pay employment taxes under section 7202, one for each open year of the criminal statute of limitations under section 6531. While the limitation period for criminal tax charges is normally three years under section 6531, the indictment asserts that Wonka’s complete failure to report any information about his workers to the IRS places his case in the willfulness exception, expanding the period to six years.

Charles Bucket, Wonka’s attorney and friend, told Tax Analysts that the dispute would be better characterized as an accidental, or at best negligent, mistake. “He pays his workers in lodging and food they particularly love — cocoa beans — and thought that fit the exceptions for convenience of the employer.”

Bucket is the only person, other than Wonka, known to have entered and returned from Wonka’s factory since it resumed operations. Being a general business attorney, Bucket said he is looking for a lawyer who specializes in criminal tax cases to take over Wonka’s defense, especially because Bucket may be called as a witness concerning Wonka’s employment practices.

Have an April Fools idea for us? Email it to aprilfools@taxanalysts.org.

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— Fred Stokeld,
Contributing Editor
Only in the publications of Tax Analysts
Technical Flaw in Anti-Loss Importation Regs

To the Editor:

I read with interest the news story on the final regulations (T.D. 9759) regarding transfers of loss property to corporations under sections 334(b)(1)(B) and 362(e)(1). (Related coverage: p. 44.) I write this letter to point out a technical error of law in the final regulations that I thought would have been corrected based on comments I had previously made. (See Monte A. Jackel, “Transferred Partnership Interests in Incorporation Transactions,” Tax Notes, Nov. 14, 2011, p. 877, for general background on the interaction between section 357(d), section 752, and Rev. Rul. 80-323, 1980-2 C.B. 124; I made extensive oral comments to the government about the issue noted here at about the time the section 362(e)(2) regulations were finalized and the section 362(e)(1) regulations were proposed a few years back.)

Specifically, the technical error is that section 357(d), as I pointed out in my referenced Tax Notes article, effectively overruled Rev. Rul. 80-323. That revenue ruling applies section 752(d) in testing for gain recognition under section 357 and in applying the tax basis consequences under section 358 on the transfer of a partnership interest to a corporation when the transferred interest has allocated to it a share of partnership debt. The problem is that after the enactment of section 357(d) over a decade ago, transfers of property along with attributable debt, including partnership interests, to corporations are treated as “assumed” (including being “subject to”) based on the rules of section 357(d).

This statute may well provide a different answer on a transfer of a partnership interest with a share of debt to a corporation as compared with the answer under section 752 and its underlying regulations. It is hard to tell exactly where differences between sections 357(d) and 752 may arise, because although section 357(d) applies to transfers of all encumbered property, including partnership interests, there are no regulations or other meaningful government guidance on the operation of section 357(d).

The final section 362(e)(1) regulations clearly apply section 752 on the transfer of partnership interests with a share of partnership debt without any mention in either the preamble or the text of the regulation to section 357(d). (See reg. section 1.362-3(c)(4)(ii) and -3(f), Example 5(iv).) How could the government issue these regulations in final form without at least mentioning that section 357(d) could be an issue on a transfer of a partnership interest in specific cases? The error persists as well in the final section 362(e)(2) regulations. Will this technical error of law ever be corrected?

Monte A. Jackel
Jackel Tax Law
Mar. 27, 2016

SUBMISSIONS TO TAX NOTES

Tax Notes welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation’s tax policymakers, academics, and practitioners. To be considered for publication, articles should be sent to the editor’s attention at tax.notes@taxanalysts.org. Submission guidelines and FAQs are available at taxanalysts.com/submissions.
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GOVERNMENT EVENTS

Monday, April 4
TAS. The Taxpayer Advocate Service will hold a public forum in Hendersonville, North Carolina, to discuss the IRS’s future state vision and what taxpayers want and need from the IRS in order to fulfill their tax obligations. National Taxpayer Advocate Nina Olson and Rep. Mark Meadows, R-N.C., will lead the forum. For more information, visit: http://www.taxpayeradvocate.irs.gov/news/next-public-forum-on-taxpayer-service-needs-and-preferences-to-be-held-in-hendersonville-nc-on-april-4.

Tuesday, April 5
IRS/TAP. The Taxpayer Advocacy Panel Special Projects Committee has scheduled an open meeting to be held via teleconference at 1 p.m. ET. For more information, contact Oluwafunmilayo Taylor at (888) 912-1227.

Tuesday, April 17
IRS. The IRS will host an information session for its “Tax Design Challenge,” a contest open to the public with a top prize of $10,000 that is soliciting designs for organizing and presenting online tax information based on the IRS’s future state vision. Online registration: https://www.eventbrite.com/e/tax-design-challenge-kickoff-at-1776-tickets-23103120054.

Wednesday, April 20
IRS/TAP. The Taxpayer Advocacy Panel Toll-Free Phone Line Project Committee has scheduled an open meeting to be held via teleconference at 2:30 p.m. ET. For more information, contact Linda Rivera at (888) 912-1227.

Thursday, April 21
IRS/TAP. The Taxpayer Advocacy Panel Communications Project Committee has scheduled an open meeting to be held via teleconference at 3 p.m. ET. For more information, contact Antoinette Ross at (888) 912-1227.

Wednesday, April 27
IRS/TAP. The Taxpayer Advocacy Panel Notices and Correspondence Project Committee has scheduled an open meeting to be held via teleconference at 12 p.m. ET. For more information, contact Theresa Singleton at (888) 912-1227.

Thursday, May 19
IRS. The IRS has scheduled a hearing on proposed regulations (REG-125761-14) that would modify the nondiscrimination requirements applicable to specified retirement plans that provide additional benefits to a grandfathered group of employees following some changes in the coverage of a defined benefit plan or formula. The hearing is set for 10 a.m. in the IRS Auditorium. For more information, contact Oluwafunmilayo Taylor at (202) 317-6901.

MEETINGS AND SEMINARS

Tuesday, April 5
Tax Compliance for Exempt Hospitals — Webinar. The American Bar Association Section of Taxation has scheduled this program to discuss how tax-exempt hospitals can comply with the IRS’s final section 501(c)(4) regulations. Online registration: http://shop.americanbar.org/ebus/ABAEventsCalendar/EventDetails.aspx?prodId=238715855.

Wednesday, April 6

Understanding Administrative Tax Controversy Cases — Webinar. This program from the American Bar Association Section of Taxation will provide a practical discussion on how to represent clients during examination and appeals conferences, with a focus on the various issues that may come up during an administrative tax controversy case. Online registration: http://shop.americanbar.org/ebus/ABAEventsCalendar/EventDetails.aspx?prodId=238445186.

Monday, April 11
Enrolled Actuaries Meeting — Washington. The American Academy of Actuaries and the Conference of Consulting Actuaries will hold their 41st annual Enrolled Actuaries Meeting. This three-day event will include panel discussions and workshops covering a variety of employee plans issues. Online registration: http://www.ccaactuaries.org/eventregistration/details?meetingId=718A2A8A-7160-E411-84E3-0050683000D.
**TAX CALENDAR**

**Tuesday, April 12**

**Talking Tax Series — Webcast.** This program from PwC will provide an update on the latest tax policy news, including legislative developments, corporate identity theft, and the changes being made to the IRS Large Business and International Division. Online registration: [http://meetpwc.ventevent/events/talking-tax-webcast-22/event-summary-fc0990bee2774ebb5c17694ec05f.aspx?ci=0c13262-6c00-45be-8275-8d2fd81a91df](http://meetpwc.ventevent/events/talking-tax-webcast-22/event-summary-fc0990bee2774ebb5c17694ec05f.aspx?ci=0c13262-6c00-45be-8275-8d2fd81a91df).

**Wednesday, April 13**


**Current Tax Developments — Webinar.** The American Bar Association Section of Taxation has scheduled a webinar to review major legislative enactments, judicial decisions, rulings, and regulations for the past year concerning individual, corporate, partnership, and estate and gift taxation. Online registration: [http://shop.americanbar.org/ebus/ABAEventsCalendar/EventDetails.aspx?produrnid=239942321](http://shop.americanbar.org/ebus/ABAEventsCalendar/EventDetails.aspx?produrnid=239942321).

**ALI-CLE Employee Benefits Conference — San Francisco.** The American Law Institute-Continuing Legal Education will hold a three-day conference to examine insights and strategies for retirement, health, and executive compensation plans. This event will feature discussions by leading legal experts on important changes from 2015 and what to expect in 2016. Online registration: [https://www.ali-cle.org/index.cfm?fuseaction=courses.course&course_code=COX31&etum_source=Real+Magnet&etum_medium=Email&utm_campaign=COX31%20%20%20%20%20EM2](https://www.ali-cle.org/index.cfm?fuseaction=courses.course&course_code=COX31&etum_source=Real+Magnet&etum_medium=Email&utm_campaign=COX31%20%20%20%20%20EM2).

**Tax Audits and Litigation Series — Washington.** The District of Columbia Bar will host a luncheon program sponsored by the Tax Audits and Litigation Committee of the D.C. Bar Taxation Section. This event is part six of a seven-part series hosted by the D.C. Bar on tax audits and litigation issues. Online registration: [https://www.dcbar.org/marketplace/event-details.cfm?productCd=1616f47tctcs&type=event](https://www.dcbar.org/marketplace/event-details.cfm?productCd=1616f47tctcs&type=event).

**Monday, April 18**


**Wednesday, April 19**

**Transfer Pricing Update — New York.** Networking Seminars will hold this two-day program on transfer pricing. This program will cover recent developments affecting transfer pricing, with a focus on the OECD’s base erosion and profit-shifting project, as well as the latest transfer pricing technologies. Online registration: [http://www.networkingseminars.com/seminars/intro-ny](http://www.networkingseminars.com/seminars/intro-ny).

**NYU/KPMG Global Tax Symposium — New York.** New York University and KPMG LLP will jointly host a one-day symposium on changes in international taxation. Throughout the day, panels will discuss topics such as U.S. tax treaty policy, international tax reform, and foreign reactions to the OECD’s base erosion and profit-shifting project. Online registration: [http://events-meetings.kpmg.com/events/16th-annual-nyu-kpmg-tax-lecture/event-summary-b52ac2a96e294de9e15c683d8b2a145.aspx](http://events-meetings.kpmg.com/events/16th-annual-nyu-kpmg-tax-lecture/event-summary-b52ac2a96e294de9e15c683d8b2a145.aspx).

**Corporate Tax Series — Washington.** The District of Columbia Bar will host a luncheon program sponsored by the Corporate Tax Committee of the D.C. Bar Taxation Section. This event is part four of a five-part series of luncheons on corporate tax issues. Online registration: [https://www.dcbar.org/marketplace/event-details.cfm?productCd=1616f47TCTCS&type=event](https://www.dcbar.org/marketplace/event-details.cfm?productCd=1616f47TCTCS&type=event).

**Wednesday, April 20**

**Arm’s-Length Standard Seminar — New York.** The International Tax Institute will host a seminar on the OECD’s base erosion and profit-shifting project, the Arm’s-length decision, and whether the arm’s-length standard can be applied to all related-party transactions. Online registration: [http://www.shop.internationaltaxinstitute.org/](http://www.shop.internationaltaxinstitute.org/).

**Thursday, April 21**


**Global Tax Attribute Tracking — Webcast.** Grant Thornton LLP has scheduled a webcast on recent developments and possible opportunities affecting multinational companies’ global tax attributes. This program will include discussion of earnings and profits, foreign tax credits, and how a company’s global tax attributes affect its financial statements. Online registration: [http://eventregistration.preregister.jsp?eventid=1160589&sessionionid=1&key=02030D0A53C742FEECA246FAD2216A914C&cl=ede5c502xkaxXrVnAdGFL4lm9yw%3d%3d%3d](http://eventregistration.preregister.jsp?eventid=1160589&sessionionid=1&key=02030D0A53C742FEECA246FAD2216A914C&cl=ede5c502xkaxXrVnAdGFL4lm9yw%3d%3d%3d).

**Tax Practice Monthly — Webcast.** This program from the American Institute of Certified Public Accountants will provide tax practitioners with the opportunity to reflect on the 2016 tax filing season and discuss tips and best practices for managing clients and workflow in the future. Online registration: [http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Tax/PRDOVR-PC-WC1125110/PC-WC1125110.jsp](http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Tax/PRDOVR-PC-WC1125110/PC-WC1125110.jsp).

**Monday, April 25**

**Tax Reporting and Withholding Conference — Arlington, Va.** The Tax Reporting Group will hold its 39th annual Tax Reporting and Withholding Conference. This three-day event will cover the latest developments in reporting and withholding; reporting savings, health, and retirement plan contributions and distributions; and the Foreign Account Tax Compliance Act. Online registration: [http://www.taxreportinggroup.com/trainingevents.html](http://www.taxreportinggroup.com/trainingevents.html).

**Tuesday, April 26**

**Tax Planning for Partnerships, LLCs, and Joint Ventures — Chicago.** The Practising Law Institute will hold a conference on tax planning in 2016 for domestic and foreign partnerships, limited liability companies, joint ventures, and other strategic alliances. This event will provide a general overview of partnership taxation as well as more advanced sessions on a variety of partnership taxation issues. Online registration: [http://www.pli.edu/Content/Session/Tax_Planning_for_Domestic_Foreign_Partnerships/_N4kZix11l6y7Nso_rdate%00ID=239142](http://www.pli.edu/Content/Session/Tax_Planning_for_Domestic_Foreign_Partnerships/_N4kZix11l6y7Nso_rdate%00ID=239142).

**Construction: Accounting, Auditing, and Tax — Webcast.** This course from the American Institute of Certified Public Accountants examines the most recent updates and key issues affecting construction accounting, auditing, and taxation. This program will review audit planning and procedures, long-term contracts, and tax issues for small to large contractors. Online registration: [http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Tax/PRDOVR-PC-CAAT/PC-CAAT.jsp](http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Tax/PRDOVR-PC-CAAT/PC-CAAT.jsp).

For more Tax Notes content, please visit [www.taxnotes.com](http://www.taxnotes.com).
Thursday, April 28

**BEPS Update — Webcast.** Deloitte Tax LLP has scheduled a webcast to provide an update on the OECD’s base erosion and profit-shifting project with a focus on global supply chains and intellectual property and how companies can plan for the new global tax environment.

**Financial Products Tax Series — Washington.** The District of Columbia Bar will hold a luncheon program sponsored by the Financial Products Committee of the D.C. Bar Taxation Section. This is the final event in a five-part series of luncheons on financial products issues. Online registration: https://www.dcbar.org/marketplace/event-details.cfm?productID=16I643TPFC&subtype=event.

Sunday, May 1

**OffshoreAlert Conference — Miami.** The 14th annual North American OffshoreAlert Conference will feature discussion from clients, providers, and investigators of high-end financial products and services and discuss a variety of financial issues, including tax fraud and evasion. Online registration: http://www.offshorealert.com/conference/miam i/.

Monday, May 2

**Taxation of Intellectual Property — San Francisco.** Networking Seminars Inc. will hold its fifth annual seminar on the taxation of intellectual property. This two-day event will provide a technical update on the latest tax planning techniques for maximizing the value of intellectual property. Online registration: http://www.networkingseminars.com/semin ars/taxation-of-intellectual-property.

**Introduction to U.S. International Tax — San Francisco.** Networking Seminars Inc. has scheduled this two-day program on the fundamentals of U.S. international taxation. This program will discuss the tax code and tax reporting requirements for U.S. companies with operations abroad. Online registration: http://www.networkingseminars.com/seminars /intro-sl.

**ABA May Meeting — Washington.** The American Bar Association Section of Taxation will hold its 2016 May meeting, bringing together the nation’s top tax practitioners and government officials to discuss the latest tax-related developments, topics, and legislation. Online registration: http://shop.americanbar.org/e bus/ABAEventsCalendar/EventDetails.asp?productID=203364691.

Friday, May 6


Monday, May 9

**Construction: Accounting, Auditing, and Tax — Webcast.** This course from the American Institute of Certified Public Accountants examines the most recent updates and key issues affecting construction accounting, auditing, and taxation. This program will review audit planning and procedures, long-term contracts, and tax issues for small to large contractors. Online registration: http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/PRDOVR–PC-VCAT/PC-VC ATjsp.

**Tuesday, May 10**

**International Tax Planning for Small Tax Practitioners — Webcast.** This program from the American Institute of Certified Public Accountants will help small tax practitioners better understand international tax and planning issues and how to minimally affect international clients. Online registration: https://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/PRDOVR–PC-WC1128793/PC-WC1128793.jsp.

**Tax Planning for Partnerships, LLCs, and Joint Ventures — New York.** The Practising Law Institute will hold a conference on tax planning in 2016 for domestic and foreign partnerships, limited liability companies, joint ventures, and other strategic alliances. This event will provide a general overview of partnership taxation, as well as more advanced sessions on a variety of partnership taxation issues. Online registration: http://www.pli.edu/Content/Se minar/Tax_Plan ning_for_Domestic_Fore ign_Partnerships/N-4kJIz1fj8y?Ns=sor t_date%60&Id=259142.

**Professional Responsibility and the IRBS — Webcast.** This program from Tax Talk Today will feature a panel of IRS and industry experts discussing changes to the rules governing practice before the IRS and the likelihood of further rule changes in the future. This program will also cover ethical problems frequently faced by tax practitioners. Online registration: https://www.taxtalktoday.com/pro grams/051016.cfm.

**Employee Benefits Plans Conference — Las Vegas.** The American Institute of Certified Public Accountants will hold a conference on employee benefits plans. This three-day event will cover a variety of accounting topics concerning employee benefit plans, including plans for tax-exempt organizations and multiemployer plans. Online registration: http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/PRDOVR-P C-EMPREN/PC-EMPREN.jsp.

**Wednesday, May 11**

**ACA Tax and Insurance Ramifications — Webcast.** This program from the American Institute of CPAs will discuss the ongoing implementation of the Affordable Care Act’s tax and insurance provisions, including premium tax credits, the individual and employer mandates, and the small business health insurance tax credit. Online registration: http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/PRDOVR–PC-VCHCRA/PC-VCHCRA.jsp.

Thursday, May 12

**Tax Basis Step-Up Transactions — Webcast.** Grant Thornton LLP has scheduled a webcast to discuss the pros and cons of tax basis step-up transactions and the various options for structuring these transactions. Online registration: http://www.grantthornton.com/events/tax/201 6/05-12-tax-basis-step-up-transactions.asp?clde=d50G0X2kvaXRvnenNAdGF4Lm 9yZw%3d%3d.

**Monday, May 16**

**New Tax Laws for Partnerships — Webcast.** This webcast from the American Institute of Certified Public Accountants will review the new IRS examination and tax collection regime for partnerships and limited liability entities. This program will cover how the new rules compare to the old rules and provide advisers and clients with issues to be aware of concerning existing or future partnership or LLC agreements. Online registration: http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/PRDOVR–PC-WC1128384/PC-WC1128384.jsp.

**Intermediate U.S. International Tax Seminar — Washington.** Networking Seminars has scheduled a seminar on key concepts in tax planning for U.S. multinational companies. This two-day event will provide tax practitioners with details on how to reduce taxes on worldwide income through effective tax planning. Online registration: http://www.networkingseminars.com/seminars/interm-tax-dc.

**Tuesday, May 17**

**Corporate Tax Series — Washington.** The District of Columbia Bar will hold a luncheon program sponsored by the Corporate Tax Committee of the D.C. Bar Taxation Section. This event is part of a five-part series of luncheons on corporate taxation issues. Online registration: https://www.dcbar.org/marketplace/event-details.cfm?productID=16I6487TCS&type=event.

**Wednesday, May 18**

**Tax Audits and Litigation Series — Washington.** The District of Columbia Bar will hold a luncheon program sponsored by the Tax Audits and Litigation Committee of the D.C. Bar Taxation Section. This event is the final session in a seven-part series of luncheons hosted by the D.C. Bar on tax audits and litigation issues. Online registration: https://www.dcbar.org/marketplace/event-details.cfm?productID=16165STACS&type=event.
TAX CALENDAR

Thursday, May 19

Wednesday, May 25
International Tax Series — Washington. The District of Columbia Bar will host a luncheon program sponsored by the International Tax Committee of the D.C. Bar Taxation Section. This event is part six of a six-part series of lunches on international tax issues. Online registration: https://www.dbar.org/marketplace/event-details.cfm?produtcID=161677ITICS&stype=event.

Wednesday, June 1
Dealing With Tax Related Identity Theft — Washington. The American Institute of CPAs has scheduled a webinar to examine how taxpayers and tax practitioners can identify when fraud is taking place, properly report identity theft, and repair the damage caused by identity theft. Online registration: http://www.cpa2biz.com/AST/Main/CPA2BIZ_Prim ary/PRDOVR-PC-WC1103615/PC-WC1103615.jsp.

Friday, June 3
Advising Nonprofit Organizations — New York/Webcast. This one-day seminar from the Practising Law Institute will examine fundamental concepts and new developments in federal and state laws concerning nonprofits. Online registration: http://www.pli.edu/Content/Seminar/Advising_Nonprofit_Organization s_2016/_N-4kZ1z1h4p7Ns=sort_date%7c0&ID=260108.

Monday, June 6
Basic Income Tax Accounting — Los Angeles. This two-day event from Networking Seminars will help tax practitioners better understand taxes payable or refundable for the current year and deferred tax assets and liabilities. Online registration: http://www.networkingseminars.com/tax-seminars/acs-la.

Introduction to U.S. International Tax — Los Angeles. Networking Seminars has scheduled this two-day program on the fundamentals of U.S. international taxation. This program will discuss the tax code and tax reporting requirements for U.S. companies with operations abroad. Online registration: http://www.networkingseminars.com/tax-seminars/intro-la.

Tuesday, June 7
Tax Planning for Partnerships, LLCs, and Joint Ventures — San Francisco. The Practising Law Institute will hold a conference on tax planning in 2016 for domestic and foreign partnerships, limited liability companies, joint ventures, and other strategic alliances. This event will provide a general overview of partnership taxation as well as in-depth sessions on a variety of partnership taxation issues. Online registration: http://www.pli.edu/Content/Seminar/Tax_Plan ning_for_Domestic_Foreign_Partnership s/_N-4kZ1z1ij8yN=sort_date%7c0&ID =289142.

Wednesday, June 8
International Tax Withholding and Reporting Forum — New York. The Executive Enterprise Institute will hold its 28th annual International Tax Withholding and Information Reporting Forum, featuring discussion of the latest withholding and reporting issues by industry experts and IRS officials. This three-day conference will examine compliance issues with the Foreign Account Tax Compliance Act, upcoming section 871(m) rules, and how to manage the risks of an IRS audit. Online registration: http://www.event.com/events/28th-annual-for um-on-international-tax-withholding-infor mation-reporting-in-new-york/event-su mmary-81a0f4dd9b9e4f48a4312164fcf24a8.aspx.

U.S.-Latin America Tax Planning Strategies — Miami. The American Bar Association Section of Taxation will hold its 9th annual conference on U.S. and Latin America tax planning strategies. This three-day event will feature workshops on wealth and asset planning, as well as a workshop for tax executives managing a multinational corporation’s tax compliance, tax reporting, and tax planning. Online registration: http://shop.americanbar.org/ebus/ABAEventsCalen dard/EventDetails.aspx?productID=238714218.

Thursday, June 9
Historic Tax Credit Conference — Washington. The Institute for Professional and Executive Development will hold its Annual Historic Tax Credit Summit. This two-day event will give investors, developers, and tax practitioners a comprehensive look at the current environment for the historic tax credit (HTC). Sessions will cover how to combine the HTC with other development-related tax credits and how to comply with IRS rules and regulations concerning the HTC. Online registration: http://www.ipedconference.com/conferences/Annual_Historic_Tax_Credit_Summit_2016_IPED.aspx.


Wednesday, June 22
International Estate and Tax Planning — New York/Webcast. The Practising Law Institute has scheduled a seminar on international estate and tax planning issues, including compliance with the Foreign Account Tax Compliance Act, strategies for dealing with double taxation, and foreign account voluntary disclosure programs. Online registration: http://www.pli.edu/Content/Seminar/I nternational_Estate_Tax_Planning_2016/ _N-4kZ1z1ij8nN=sort_date%7c0&ID =260442.

TAX ADMINISTRATION

April 6
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on March 30-April 1.

April 8
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 2-5.

April 11
Employees who work for tips. If you received $20 or more in tips during March, report them to your employer. You can use Form 4070.

April 12
Communications and air transportation taxes under the alternative method. Deposit the tax included in amounts billed or tickets sold during the first 15 days of March.

April 13
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 6-8.

April 14
Regular method taxes. Deposit the tax for the last 16 days of March.

April 18
Individuals. File a 2015 income tax return (Form 1040, 1040A, or 1040EZ) and pay any tax due. If you are a resident of Massachusetts or Maine, Patriots’ Day (April 18) delays the due date for filing your income tax return until April 19. If you want an automatic six-month extension of time to file the return, file Form 4868. For more information, see Form 4868. Then, file Form 1040, 1040A, or 1040EZ by October 17.

Individuals. If you aren’t paying your 2016 income tax through withholding (or won’t pay in enough tax during the year...
that way), pay the first installment of your 2016 estimated tax. Use Form 1040-ES. For more information, see Publication 505.

Household employers. If you paid cash wages of $1,900 or more in 2015 to a household employee, you must file Schedule H (Form 1040), “Household Employment Taxes.” If you are required to file a federal income tax return (Form 1040), file Schedule H (Form 1040), “Household Employment Taxes,” with the return and report any household employment taxes. Report any federal unemployment (FUTA) tax on Schedule H (Form 1040) if you paid total cash wages of $1,000 or more in any calendar quarter of 2014 or 2015 to household employees. Also, report any income tax you withheld for your household employees. For more information, see Publication 926.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 9-12.

April 20
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 13-15.

April 22
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 16-19.

April 27
Communications and air transportation taxes under the alternative method. Deposit the tax included in amounts billed or tickets sold during the last 16 days of March.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 20-22.

April 29
Regular method taxes. Deposit the tax for the first 15 days of April.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 23-26.

May 2
Social Security, Medicare, and withheld income tax. File Form 941 for the first quarter of 2016. Deposit or pay any undisposed tax under the accuracy of deposit rules. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter timely, properly, and in full, you have until May 10 to file the return.

Federal unemployment tax. Deposit the tax owed through March if more than $500.

Form 720 taxes. File Form 720 for the first quarter of 2016.

Wagering tax. File Form 730 and pay the tax on wagers accepted during March.

Heavy highway vehicle use tax. File Form 2290 and pay the tax for vehicles first used in March.

May 4
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 27-29.

May 6
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on April 30-May 3.

May 10
Employees who work for tips. If you received $20 or more in tips during April, report them to your employer. You can use Form 4070.

Social Security, Medicare, and withheld income tax. File Form 941 for the first quarter of 2016. This due date applies only if you deposited the tax for the quarter timely, properly, and in full.

May 11
Communications and air transportation taxes under the alternative method. Deposit the tax included in amounts billed or tickets sold during the first 15 days of April.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on May 4-6.

May 13
Regular method taxes. Deposit the tax for the last 15 days of April.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on May 7-10.

May 16
Social Security, Medicare, and withheld income tax. If the monthly deposit rule applies, deposit the tax for payments in April.

Nonpayroll withholding. If the monthly deposit rule applies, deposit the tax for payments in April.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on May 11-13.

May 20
Social Security, Medicare, and withheld income tax. Deposit the tax for payments on May 14-17.

May 25
Communications and air transportation taxes under the alternative method. Deposit the tax included in amounts billed or tickets sold during the last 15 days of April.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on May 18-20.

May 27
Regular method taxes. Deposit the tax for the first 15 days of May.

Social Security, Medicare, and withheld income tax. Deposit the tax for payments on May 21-24.

May 31
Wagering tax. File Form 730 and pay the tax on wagers accepted during April.

Heavy highway vehicle use tax. File Form 2290 and pay the tax for vehicles first used in April.
April 2016 Tax Crossword Puzzle

By Myles Mellor

Across
1 Senator proposing a bill to end the prescription drug advertising deduction
5 Prominent politician proposing a flat tax
9 C-level member, abbr.
12 Unpaid portions
14 Trial attorney’s concern in criminal cases
16 Tokyo coin
17 State that recently passed a cigarette tax hike, abbr.
18 Jupiter’s moon
20 Political figure
21 New Hampshire governor who ran a successful tax amnesty program in 2015
24 Get off the fence
27 Brit finance system
28 Punishment for tax related identity theft
29 Gross receipts style tax in force in Texas
30 Secretary of the Treasury, Jack ___
32 You, in old British court parlance
34 Now I understand!
35 Think through
36 It refers to the negative effect of multinational companies’ tax avoidance strategies on national tax bases, a subject now under consideration by the IRS
38 Abbreviation for dealer
40 Celebrity
42 It’s being phased out by digital
43 Association urging Treasury to update the taxation of cross-border savings in relation to the U.S. and Canada
45 Commissioner of Internal Revenue was created under this president
47 Distinguished
48 Make a wrong move
49 Justice Alito has indicated the Supreme Court may accept a case to review the constitutionality of these laws in the future
50 One who often gets an inheritance

Down
1 State tax organization in California, abbr.
2 Unite
3 Philadelphia mayor proposing a tax on sugary beverages
4 Reason for some grants
6 Pacific ___
7 Greek letters
8 House Ways and Means Committee Chairman, first name
10 Roman eleven
11 Cook, for Apple
13 ___ Lingus (Irish airline)
15 National Tax Payer Advocate, Nina ___
19 Government org. that is featured in The Firm movie
21 California Democrats voted to extend higher income tax brackets for this demographic, 2 words
22 A. Onassis, familiarly
23 Everyone
25 British wage and tax system which records changes in earnings in real time
26 Agreement between nations regarding exchange of tax information
27 Seize
31 Funding this was the original reason income tax was imposed in the U.S.
33 Technicality in tax law
35 Change a property’s tax assessment amount
37 Supreme Court Judge recently passed
38 Case lists
39 ___ the ante
41 Kind of button, pressed when under severe stress
44 React to (2 words)
46 After tax amount

See p. 64 for the solution.