NEWSQUARTERLY

SPRING 2005
Volume 25 Number 3

SECTION OF TAXATION

2005 JOINT FALL CLE MEETING

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SAN FRANCISCO SEPTEMBER 15-17 – PARK HYATT & HYATT REGENCY

INSIDE

- It has been a busy time for the Section, as Ken Gideon illustrates in "From the Chair"
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- Michael Graetz shares his views on tax reform and social security
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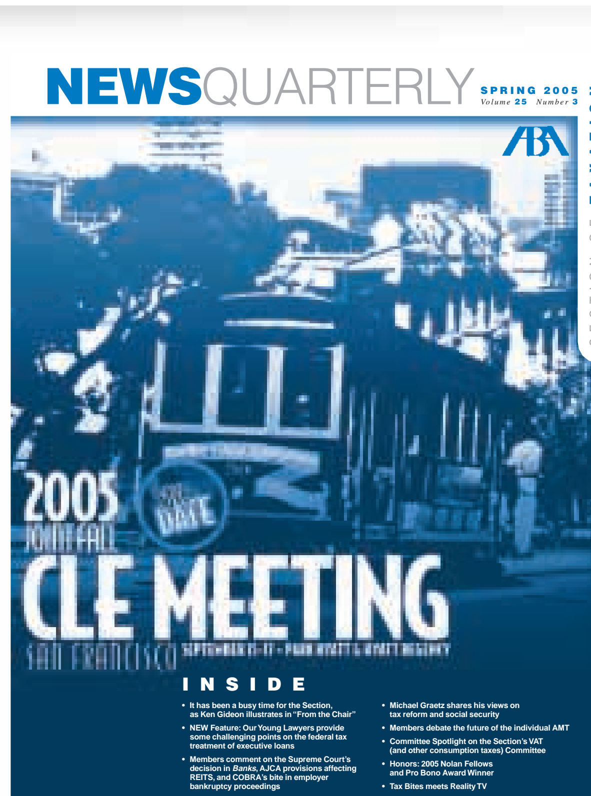

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FROM THE **CHAIR**

by Kenneth W. Gideon, Washington, DC

KENNETH W. GIDEON

Secretary of the Treasury John Snow will speak at our May meeting at our breakfast session on May 20, 2005. This timely appearance will provide Tax Section members the opportunity to hear directly from the Secretary about the Administration's objectives for social security and tax reform. While those wishing to attend must request a ticket, there is no additional charge for attendance.

MATERIAL ADVISOR **DEVELOPMENTS**

On February 24, 2005, the Treasury and IRS issued Notice 2005-22 clarifying requirements for material advisors. The Notice adopted the suggestion made by the Tax Section and others that such reporting should not be required unless and until a taxpayer enters into a transaction. Adopting another Tax Section comment, the Notice provides that Forms 8264 reporting material advisor status are to be filed on a calendar quarter basis, with the due date being 30 days after the end of each quarter. The Tax Section's comments on these topics appear on our public policy website at www.abanet.org/tax/pubpolicy.

IRS OVERSIGHT BOARD **TESTIMONY**

On February 1, 2005, I testified before the IRS Oversight Board on initiatives to improve tax administration through administrative simplification. This testimony is also available on the Section's public policy website.

RETAINING TAX SIMPLIFICATION **AS AN ABA PRIORITY**

Our Section persuaded the ABA Board of Governors to retain tax simplification as a legislative priority of the Association at its Mid-Year Meeting in February, 2005, in Salt Lake City. Critics had challenged the priority as "too vague," but the Board ultimately adopted our view that a commitment to simplification was important and provided an umbrella of support under which efforts such as last year's "uniform definition of a child" legislation could be fostered.

BLANKET **AUTHORITY**

The Operations Committee of the Board of Governors has recommended revisions to the blanket authority rules for technical comments. These revisions, when ultimately adopted, should provide important clarifications concerning how the revised comment process will function and permit our Section to continue its long-standing practice of submitting comments on government regulations and notices within our area of expertise. Until the ABA Annual Meeting in August, 2005, we expect to continue filing comments under our existing procedures.

SAN DIEGO MEETING/ **NOLAN FELLOWS**

The Mid-Year Meeting of the Section in San Diego attracted over 1,100 members and served as an important forum for discussion with government representatives of guidance on the new tax acts and Circular 230. Tapes and/or CDs of these important sessions can be purchased via the Section's website at www.abanet.org/tax/pubs/tapes.

At that meeting, the Section announced its next class of Nolan Fellows: **Arlene Suzanne Fitzpatrick, Peter A. Furchi, Gregory J. Gawlik, Brant Hellwig, Michael M. Lloyd, and Jeanne Newlon**. The Nolan Fellows program honors younger tax lawyers who have demonstrated significant commitment to the Tax Section and whom we hope will become part of its future leadership.

RECENT TAX SECTION **SUBMISSIONS**

All of our Section's submissions to the government are available on our public policy website at www.abanet.org/ tax/pubpolicy. Among recent submissions are comments to the Public Accounting Oversight Control Board on auditor independence and to the Congress on technical corrections.

MAY **MEETING**

Secretary Snow's remarks will highlight another extraordinary program. The Employee Benefits Committee is sponsoring a luncheon on Saturday, May 21, 2005, at which Professor Michael Graetz will speak on social security issues. (Separate tickets must be purchased for this event). Our Section reception will be held at the National Women's Museum, just a short walk from our headquarters hotel. Our committees, as the advance program demonstrates, will present the latest developments and provide a forum for a number of government speakers. I look forward to seeing you there. ■

CHALLENGE POINTS

EDITOR'S NOTE: We are pleased to be able to introduce a new feature, which will appear occasionally in the *NewsQuarterly*. This feature will highlight issues that formed a part of the **Law Student Tax Challenge**, organized and sponsored by the **Young Lawyers Forum**, but which are of general importance and worth sharing with the membership as a whole. We hope you find the feature interesting and useful. We welcome your comments and reactions, and encourage you to send ideas for issues to be featured in future Challenges to the YLF at mlloyd@milchev.com and LSTCcochairs@hotmail.com. —*Alice G. Abreu, Philadelphia, PA*

FORGIVEN EXECUTIVE LOANS: COMPENSATION INCOME WITH SOME UNSAVORY TWISTS

by Michael M. Lloyd, Washington, DC and Veronica A. Rouse[1], Washington, DC

This article analyzes the federal tax treatment of a discharge of loans made by a corporation to executive officers of the corporation's wholly owned subsidiary. This issue remains important even though section 402(a) of the Sarbanes-Oxley Act of 2002 ("SOX") prohibits a public company from extending credit to an executive officer or director of the company on or after July 30, 2002. While prospective loans may no longer be made by public companies to their executive officers and directors after July 29, 2002, section 402(a) of SOX grandfathers loans in existence on the date of enactment. In addition, section 402(a) of SOX does not apply to non-public companies. Accordingly, practitioners are likely to continue to face issues that arise in connection with employee loans.

THE TRANSACTION

Assume that a corporate parent ("Distributing") announces its intention to distribute the shares of stock in a wholly owned subsidiary ("Controlled") in a spin-off qualifying under section 355. Further assume that Distributing made loans to certain executive officers of Controlled to finance the purchase and retention of Distributing shares by those executive officers. Those loans are evidenced by notes issued to Distributing by the executives. In connection with the spin-off, Distributing wants to forgive the loans made to the executives following the spin-off, but it needs to establish the federal income and employment tax consequences of any such forgiveness. The executives would like to be able to take the position that the forgiveness constitutes neither income nor wages, but instead simply amounts to a purchase-price adjustment in the acquired shares pursuant to section 108(e)(5). If section 108(e)(5) applies, no amounts would need to be recognized; the question practitioners in such a situation will face is whether that result is correct.

THE ANALYSIS

Although treating the loan forgiveness as a purchase price adjustment would appear to have some merit given that the lender forgiving the obligation (Distributing) is also the seller of the property, section 108(e)(5) probably does not apply. The Service analyzed a similar situation in Rev. Rul. 2004-37, 2004-11 I.R.B. 1 and concluded that the tax consequences of such a scenario are governed by section 83 and Treas. Reg. § 1.83-4(c), not section 108(e)(5). In Rev. Rul. 2004-37 the Service treated the amount forgiven as compensation and explained its position as follows:

> Thus, if the reduction of the stated principal amount of the Note is a cancellation, forgiveness, or satisfaction of the indebtedness for an amount less than the amount of such indebtedness [with respect to the rules set forth in Treas. Reg. § 1.1001-3], the reduction of the stated principal amount is a medium for payment of compensation by Employer to Employee, and any income resulting from the reduction is not income to Employee from the discharge of indebtedness subject to the provisions of section 108. Accordingly, the tax consequences of the reduction are governed by § 83 and § 1.83-4(c), and not by § 108(a)(1)(B) or § 108(e)(5).

The Service issued Rev. Rul. 2004-37 in February of 2004 to address a fact pattern involving an employee who had issued a recourse note to his employer in satisfaction of the exercise price of an option to acquire the employer's stock. Subsequently, the employee and employer agreed to reduce the stated principal amount of the note. The ruling addressed whether the employee must recognize compensation income under section 83. The Service ruled that the employee must recognize compensation income under section 83 at the time of the reduction.

EMPLOYMENT TAX CONSEQUENCES

In Rev. Rul. 2004-37 the Service also stated that the compensation constituted wages for Federal employment tax purposes (*i.e.*, Federal Income Tax Withholding ("FITW") taxes, Federal Unemployment Tax Act ("FUTA") taxes, and Federal Insurance

1 The authors served as co-chairs of the 2004 Law Student Tax Challenge. The analysis provided here reflects only the individual views of the authors and does not represent the views held by the Internal Revenue Service.

Contribution Act ("FICA") taxes). For federal employment tax purposes, remuneration arising from the employer-employee relationship constitutes wages even though at the time of payment the individual is no longer an employee. *See* Treas. Reg. § 31.3401(a)-1(a)(5) (FITW); Treas. Reg. § 31.3121(a)-1(i) (FICA); Treas. Reg. § 31.3306(b)-1(i) (FUTA); *see also* Social Security Board v. Nierotko, 327 U.S. 358 (1946) (holding that back pay provided by an employer under the National Labor Relations Act to an illegally terminated employee for a period during which the individual performed no services for the employer was wages for social security benefit purposes). Thus, any debt-discharge income of the executives would constitute wages for federal employment tax purposes. Consistent with the Service's position in Rev. Rul. 2004-37, federal income tax and the employee share of FICA taxes should be withheld with respect to the deemed payment of the wage amount, and the employer's share of FICA taxes and FUTA taxes should be paid with respect to the same amount. *See*, *e.g.*, I.R.C. § 3402(a) and Treas. Reg. § 31.3402(a)-1(c) (requiring employers to deduct and withhold Federal income tax even if the wages are paid in a form other than money); I.R.C. §§ 3101 and 3111 (imposing FICA taxes on wages) and Treas. Reg. § 31.3102(a)-1(a) (requiring employers to deduct and withhold FICA tax regardless of the fact that the wages are paid in a form other than money); I.R.C. §§ 3301, 3306(b), and 3306(c) (combining to impose FUTA taxes on employers regardless of the fact that wages are paid in a form other than money).

Distributing is in a difficult position with respect to withholding and employment taxes arising from the debt discharge in a situation like this because although Distributing did not actually employ the executives (its subsidiary, Controlled, was the employer), Distributing was the party that exercised control over the "payment" of the wages in question (the debt discharge), and it will therefore be treated as the employer for withholding purposes. Section 3401(d)(1) provides that if the person (service recipient) for whom the individual performs or performed services does not have control of the payment of the wages for such services, the term "employer" means the person having control over the payment of such wages. Under case law, a similar result would be reached for FICA and FUTA tax purposes. *See*, *e.g.*, Otte v. United States, 419 U.S. 43 (1974); In re Armadillo Corp., 561 F.2d 1382 (10th Cir. 1977); Cencast Services, L.P. v. United States, 62 Fed. Cl. 159 (2004). In this case, then, Distributing will be treated as the employer for withholding and employment tax purposes because Controlled, the actual employer, did not control the payment of the wages attributable to the debt discharge. Distributing would thus be liable for FITW (most likely at supplemental rates of either 25 or 35 percent, as circumstances require) and FICA tax withholding in addition to paying the employer's share of Federal employment taxes for individuals whom it did not actually employ.

SEE CHALLENGE POINTS, PAGE 6

2005-2006 NOMINEES

In accordance with sections 6.1 and 6.3 of the Section of Taxation Bylaws, the following nominations have been submitted by the Nominating Committee for terms beginning at the conclusion of the 2005 Annual Meeting in August. Under the Section Bylaws, the current Chair-Elect, Dennis B. Drapkin of Dallas, TX will become Chair at the conclusion of the 2005 Annual Meeting. ■

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In addition, Distributing will face a potential liquidity problem because there is no actual payment of wages from which to withhold. If Distributing ultimately chooses to drop the notes into Controlled in a section 351 contribution prior to the spin-off, it can solve the first problem because Controlled, the actual employer, will be forgiving the indebtedness which it now holds. Nevertheless, the liquidity problem will remain because there will be no payments from which taxes may be withheld by either Distributing or Controlled; there will only be a discharge of bona fide indebtedness. Thus, Distributing or Controlled, as appropriate, could not only suffer from an inability to collect on the notes from the executives, but Distributing or Controlled would be financially responsible through secondary liability for all of the related employment taxes to be withheld (*e.g.*, FITW and the employee share of FICA taxes) with no "payment" from which to withhold. See I.R.C. § 3403 (FITW) and Treas. Reg. § 31.6205-1(b)(1) (FICA).

DEPOSIT AND PAYMENT OF TAXES

To make matters worse, the Service could take the position that the deposit rules set forth in the regulations under section 6302 apply to the debt-discharge event, which would likely require Distributing or Controlled, as appropriate, to deposit the Federal employment taxes on the day after the liability date (*i.e.*, the date of the compensation) if the amount of the liability equals or exceeds $100,000. Such a failure would likely trigger the late deposit penalties under section 6656. Nevertheless, the debt-discharge income might constitute a form of non-cash compensation to executives, which may provide some flexibility with regard to when the related federal employment taxes may be deposited. *See* Ann. 85-113, 1985-31 I.R.B. 31 (permitting employers to elect to treat non-cash fringe benefits as paid on a pay period, quarterly, semi-annual, annual, or other basis, provided that the non-cash benefits are treated as paid no less frequently than annually). Under this Announcement, employers must treat all such benefits as paid prior to December 31 of the calendar year in which they provide the benefits. Because the executive's debt discharge income is tantamount to a non-cash fringe, it may be possible for Distributing or Controlled to treat the deemed payment as a non-cash fringe for purposes of the deposit rules under section 6302.

COMPENSATION DEDUCTION

As a result of a debt discharge, Controlled would likely qualify for an additional compensation deduction under section 83 because it was the recipient of the executive officer's services and because the indebtedness was incurred to pay for section 83 property. *See* Treas. Reg. § 1.83-4(c), which provides as follows:

> If an indebtedness that has been treated as an amount paid under §1.83-1(a)(1)(ii) is subsequently cancelled, forgiven or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid shall be includible in the gross income of the service provider in the taxable year in which such cancellation, forgiveness or satisfaction occurs.

It therefore follows that Controlled, the recipient of the services, would be entitled to a corresponding deduction for the compensation paid.

JUDICIAL RELIEF

In connection with the imposition of employment taxes on the debt discharge income of the executive officers, Controlled or Distributing may attempt to argue that there is judicial authority that would mitigate the imposition of such taxes. In particular, Controlled or Distributing might argue that the Supreme Court's holding in Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978) demands more clarity in the obligation to withhold than exists under the instant facts. In *Central Illinois*, the Court held that if the employer is to function as the Government's tax collector with respect to taxes owed by the employee, the withholding obligation must be clearly apparent. Since the Court's holding in *Central Illinois*, other courts have followed this reasoning. *See*, *e.g.*, General Elevator v. United States, 20 Cl. Ct. 345 (1990); McGraw-Hill, Inc. v. United States, 623 F.2d 700 (Cl. Ct. 1980); Marquette University v. United States, 645 F.Supp. 1007 (E.D. Wis. 1985).

Nevertheless, the issuance of Rev. Rul. 2004-37 could undercut such an argument; the ruling puts taxpayers on notice of the Service's position with respect to the treatment of debt discharges for employees.

CONCLUSION

Despite the issuance of Rev. Rul. 2004-37, an important legal question remains: that is, whether the Service may impose a withholding obligation on an entity when bona fide indebtedness of a former employee or of an individual who was never actually employed by the entity is discharged, and there is no actual payment from which the entity may reasonably extract the amounts to be withheld. This question is one that the Service has, to date, failed to answer directly. While Rev. Rul. 2004-37 answered the question of how to characterize the amounts forgiven by concluding that the amounts should be treated as wages, that ruling did not grapple with the issues raised by a fact pattern in which the individual is not employed by the entity that forgives the obligation. While it seems to us that existing authority combines to produce the result set forth here, the issues raised suggest that additional guidance would be welcome and that there is at least some risk that a court would decline to impose Federal employment tax obligations on an employer in such a situation. ■

POINTS TO **REMEMBER**

OVERVIEW: Tax legislation necessarily spawns commentary, as shown by the three **POINTS** in this issue. First, David Brennen analyzes the Supreme Court's decision in **BANKS**, which is important notwithstanding the recent enactment of section 62(a)(19)[20]. Next, Eric Mikkelson examines recent changes to the provisions affecting **REITS** and generally increasing their attractiveness as investment vehicles. Finally, Frank Tripodi reminds us of **COBRA'S BITE**, which could result in unpleasant consequences for the acquiror of a business.
—Alice G. Abreu, Philadelphia, PA

SUPREME COURT RULES THAT **CONTINGENT ATTORNEY FEES** ARE GROSS INCOME TO CLIENT

by David A. Brennen, Macon, GA

In Commissioner v. Banks, 125 S. Ct. 826 (2005), the Supreme Court considered whether the portion of a monetary recovery paid to a litigant's attorney under a contingency fee agreement constitutes gross income to the litigant under section 61. Although this issue has been around for quite some time, it gained renewed importance as a result of 1996 amendments to section 104(a). Section 104(a), which used to exclude from gross income damages for "personal injuries or sickness," now only excludes non-punitive damages received on account of "personal physical injuries or physical sickness." Thus, in situations where a litigant has a recovery for punitive damages or damages that do not result from personal physical injuries or sickness, the recovery is not excluded. The question addressed by the Court in *Banks* was whether the portion of the recovery that will go to pay a contingent attorney's fee must also be included in gross income. The issue is important because, while the litigant *may* be entitled to take a deduction for the payment of contingent attorney fees at the conclusion of the case, the deduction is not guaranteed. The Court in *Banks* held that the contingent attorney fee portion of the recovery must also be included in gross income. In resolving the conflict among the circuits on this issue, the Court in *Banks* reasoned that because the attorney-client relationship is one of principal-agent, the anticipatory assignment of income doctrine requires that the client/principal include the contingent attorney fee portion of the recovery in gross income.

Banks involves the Court's review of two cases—Banks v. Commissioner, 345 F.3d 373 (6th Cir. 2003), and Banaitis v. Commissioner, 340 F.3d 1074 (9th Cir. 2003). In *Banks*, the Sixth Circuit case, a taxpayer sued his employer in federal district court under federal statutory law for employment discrimination. Shortly after the trial began, the case settled for just under one-half million dollars. The taxpayer paid his attorney $150,000 pursuant to a fee agreement. In *Banaitis*, the Ninth Circuit case, the taxpayer sued his former employer in state court under state common law. After an appeal of a jury verdict for the taxpayer, the parties settled for just under $5 million. In accordance with a contingency fee agreement between the taxpayer and his attorney, the defendants paid an additional $3.9 million to the taxpayer's attorney. In each of these cases, the taxpayer-plaintiffs did not report the portion of the recovery paid to their respective attorneys as gross income, the Service issued a notice of deficiency for failure to report the fee as income, and the Tax Court upheld the Service's determinations.

The Sixth Circuit and the Ninth Circuit reversed the Tax Court in each of these cases. The Sixth Circuit reasoned that regardless of whether state law grants the attorney a property interest in the contingency fee, the fee should be excluded from gross income because the attorney "earns his fee," not the client. The Ninth Circuit reasoned that because state law "grants attorneys a superior lien" in the fee, the fee does not constitute gross income to the client. Although their view of the relevance of state law differed, both circuit courts concluded that the contingency fee agreement represented a partial assignment by the client of income-producing property to the attorney. In so concluding, the circuit courts rejected the application of the assignment of income doctrine as a basis for including the fee in the client's gross income. The appellate courts' conclusion that attorney fees are excludable from gross income created a conflict with several other circuits that had held otherwise. The Supreme Court granted certiorari so that it could resolve the conflict.

In contrast to the Sixth and Ninth Circuits, the Supreme Court in *Banks* embraced the anticipatory assignment of income doctrine as the legal basis for requiring plaintiffs to include contingency fees in gross income. The anticipatory assignment of income doctrine provides that a taxpayer cannot exclude an economic gain from gross income by assigning that gain to another person in advance of receiving the gain. The policy advanced by the doctrine is that income should be taxed to the person who earns it. Accordingly, it is inappropriate to give tax effect to contracts that redirect earnings to another person prior to the payment of those earnings. While it is true that attorneys work to earn their fees, the fee is paid from the recovery that is derived from the plaintiff's cause of action. So long as the plaintiff maintains dominion and control of the cause of action, the plaintiff maintains control of the income-producing asset. Even though attorneys use their own skill and effort in representing the plaintiff, such skill and effort is expended in the attorney's capacity as an agent for a principal, not as a partner or joint venturer. The Court in *Banks* therefore concluded that sign-

ing a contingency fee agreement is an attempt to redirect earnings (litigation recovery) from a client to his/her attorney. By holding that the fee portion of recovery is included in the client's gross income, the Court refused to allow this anticipatory assignment of income to succeed.

The holding in *Banks* has very important ramifications for many plaintiffs who hire attorneys on a contingency fee basis. Indeed, as the Court in *Banks* explains, unless the fee is somehow deductible by the plaintiff in computing taxable income, a worst-case scenario is that a plaintiff who wins a lawsuit could end up losing money due to the resulting federal income tax obligation. The problem is that contingency fee payments to an attorney are not always fully deductible. The most likely method for an individual to deduct attorney fees is as an investment or profit seeking expense under section 212, or as an unreimbursed employee business expense under section 162.

Generally, taxpayers may only deduct section 212 expenses and unreimbursed employee business expenses as itemized (or "below-the-line") deductions. Deductions that are not itemized (or "above-the-line") deductions are generally more advantageous than below-the-line deductions because above-the-line deductions are not subject to the many limitations that restrict the tax advantage of below-the-line deductions. Additionally, above-the-line deductions are available even to taxpayers who do not itemize but take the standard deduction. Thus, Congress' 2004 enactment of section 62(a)(19)[20], which provides an above-the-line deduction for "attorney fees and costs" incurred in certain cases, including discrimination cases, means that plaintiffs like the one in *Banks* will likely not suffer any adverse tax impact by including attorney fees in gross income. However, plaintiffs who incur contingency fee obligations in cases not covered by section 62(a)(19)[20] will face the same problems that led the plaintiff in *Banks* to litigate the issue of inclusion. For example, under the Court's analysis in *Banks*, plaintiffs in defamation and invasion of privacy cases who incur contingent attorney fee obligations are not eligible for the section 104(a) exclusion and may not be eligible for the section 62(a)(19)[20] above-the-line deduction. Therefore, these plaintiffs may have gross income upon receipt of the fee portion of the recovery but only a below-the-line deduction for payment of the fee to the attorney.

The most significant problem with characterizing payment of attorney fees as a below-the-line deduction is the alternative minimum tax (AMT). The AMT mandates that individual taxpayers pay at least a 26 percent tax on "alternative minimum taxable income." In computing alternative minimum taxable income, a taxpayer takes into account all gross income used in calculating regular income (including the attorney fee portion of section 104(a) nonexcludable awards), but does not take account of many below-the-line deductions (among other things) such as section 212 deductions or unreimbursed employee business expense deductions for payment of attorney fees. So while fees are treated as income for AMT purposes, they will likely not be allowed as deductions for AMT purposes. On the other hand, the AMT problem does not exist for above-the-line deductions, such as those deductions authorized by section 62(a)(19)[20], because they are taken into account fully when calculating alternative minimum taxable income.

Even though the holding in *Banks* appears comprehensively to address issues concerning whether contingent attorney fees are includable in a client's gross income, several issues remain unresolved. For instance, the Court's holding expressly does not address whether attorney fees awarded pursuant to statutory fee-shifting provisions should be included in gross income. Arguably, application of the anticipatory assignment of income doctrine in these circumstances is inconsistent with the policy rationales that underlie fee-shifting statutes. In addition, the Court in *Banks* declined to comment on three theories proposed by *amici* in support of excluding contingency fees from a client's gross income because those theories were not examined by the courts of appeal and were raised for the first time before the Court. Those theories include: 1) The contingency fee agreement establishes a Subchapter K partnership between the client and the attorney such that the attorney fees represents the attorney's share of partnership income; 2) The attorney fees should be treated as a capital expense incurred in disposing of the "cause of action" asset in exchange for the litigation recovery; 3) The attorney fees should be treated as another type of above-the-line deduction—a reimbursed employee business expense authorized by section 62(a)(2)(A). The Court's assertion that "We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes," 125 S.Ct. at 832, seemingly forecloses further serious consideration of the partnership argument. However, it remains to be seen whether there is any meaningful difference between a "Subchapter K partnership" and a "business partnership or joint venture" which would keep the theory alive.

In conclusion, the Court's decision in *Banks*, while providing welcome certainty in one area, has failed to resolve all of the issues raised by the award of attorney fees since the amendment of section 104(a) in 1996. These issues will be important in a smaller category of cases given the enactment of section 62(a)(19)[20], but they will likely not disappear.

RECENT CODE CHANGES **FAVORABLE TO REITS**

by Eric Mikkelson, Kansas City, MO

Real estate investment trusts ("REITs") offer a tax-advantaged structure, typically by using a domestic corporation or business trust, through which large numbers of investors can own income-producing real estate and real estate mortgages. If REITs comply with several organizational, asset, income, distribution

and record-keeping rules, they can avoid entity-level federal income tax liability. Public Law 108-357 was enacted on October 22, 2004, and is known as the American Jobs Creation Act of 2004 (the "AJCA"). The AJCA contains several tax provisions that directly affect REIT qualification. The changes are generally favorable to REITs and their shareholders, and include some retroactive changes. Some of these new provisions are discussed below.

I. ASSET TEST RELAXATION

To retain its tax-favored status, the REIT must meet several asset-related tests, one of which prohibits the REIT from holding securities having a value of more than 10% of the total value of the outstanding securities of any one issuer. I.R.C. § 856(c)(4)(B)(iii)(III). This rule applies not only to equity securities, but also to debt instruments that constitute securities held by the REIT. There are exceptions for certain kinds of securities and issuers. One such exception is a safe harbor for certain "straight debt."

The AJCA expands the applicable definition of "straight debt" for purposes of qualifying under the safe harbor from the 10%-by-value REIT asset limit. The AJCA also provides that certain additional obligations will not be considered securities for purposes of this test, including loans to an individual or estate, certain loans to governments, and tenant obligations to pay rent. I.R.C. § 856(m). These changes expand the universe of assets that a REIT can hold without violating the 10%-by-value asset test. For example, a REIT can now make substantial loans to REIT employees without risking violation of that test.

The AJCA's expanded definitions of "straight debt" and excluded assets are generally applicable retroactively for tax years beginning after December 31, 2000, although a related provision establishing a new "look-through" rule for determining a REIT partner's share of partnership securities for purposes of the 10%-by-value asset test is effective for tax years beginning after October 22, 2004.

II. LESSER PENALTIES FOR FAILURE TO MEET TESTS

The AJCA also protects a REIT from the draconian penalty of revocation of its REIT tax status for failures to satisfy certain asset tests. Now, in certain cases, lesser sanctions and penalties are instead available for such violations. Accordingly, the potentially financially catastrophic threat of revocation of a REIT election is substantially eliminated for many merely-minor violations or inadvertent violations with reasonable causes, if quickly rectified upon discovery.

For example, if a failure of the 10% or 5% asset tests is due to the ownership of assets the total value of which does not exceed the lesser of i) one percent of the total value of the REIT's assets at the end of the quarter; or ii) $10 million, the REIT will not automatically lose its REIT status, provided that in either case the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period as prescribed by the Service) or otherwise meets the requirements of those asset tests by the end of that period. Further, a failure that exceeds the de minimis thresholds described above will not necessarily cause a REIT to lose its REIT status if: i) the failure was due to reasonable cause (and not willful neglect); ii) the REIT files a schedule describing each asset that caused the failure in accordance with Treasury Regulations; iii) the REIT disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or the tests are otherwise met within such period); and iv) the REIT pays a tax on such failure ($50,000 minimum tax). I.R.C. § 856(c)(7). These new AJCA provisions are effective for tax years beginning after October 22, 2004.

Similar reporting and reasonable cause standards apply now for failures to meet the REIT income tests as well. I.R.C. § 856(c)(6). The old rule that assesses the tax penalty for income test failures based on a fraction of the REIT's disqualified gross income survives, however, although the AJCA slightly modifies the formula for calculating the tax for failure to meet the 95% gross income test. I.R.C. § 857(b)(5). For failure to meet certain other requirements for REIT qualification, the AJCA permits a REIT to retain its REIT qualification if such failure was due to reasonable cause (and not willful neglect) and the REIT pays a $50,000 penalty for each such failure. I.R.C. § 856(g). These new AJCA penalty provisions are also effective for tax years beginning after October 22, 2004.

III. FIRPTA CHANGES FAVOR FOREIGN INVESTMENT

The AJCA also changed the Foreign Investment in Real Property Tax Act ("FIRPTA") in a manner that should promote foreign investment in REITs. Previously under FIRPTA, REIT capital gain distributions to foreign shareholders were treated as effectively connected with a U.S. trade or business, triggering a U.S. return filing requirement for that foreign shareholder as well as possible branch profits tax for foreign corporate shareholders, and corresponding withholding obligations on the REIT.

Under the AJCA, for tax years beginning after October 22, 2004, REIT capital gain distributions will no longer automatically be treated as income effectively connected with a U.S. trade or business (and, thus, a foreign shareholder will no longer have to file a U.S. federal income tax return solely by reason of receiving such a distribution) and will no longer be subject to the branch profits tax. Instead, such distributions will be treated as dividends that are not capital gains (dividend withholding requirements still apply to the REIT, but those rates are often reduced, even eliminated, by the applicable U.S. tax treaty), *provided that* i) the foreign shareholder recipient does not own more than 5% of that class of stock at any time during the tax year in which the distribution is received; and ii) that class of stock is regularly traded on an established U.S. securities market. I.R.C. §§ 897(h)(1), 857(b)(3)(F).

IV. OTHER CHANGES

Other AJCA changes directly affecting REITs include provisions: i) expanding the applicable definition of a "hedging transaction" and providing that certain such hedging transactions entered into to reduce interest rate risk on real estate debt will be disregarded for purposes of the REIT income tests (effective for tax years beginning after October 22, 2004); ii) eliminating a safe harbor from the 100% excise tax on deductions improperly shifted between a REIT and its taxable REIT subsidiary (effective for tax years beginning after October 22, 2004); iii) providing practical clarification of how to test whether rents a REIT receives from its taxable REIT subsidiary will qualify as "good" real estate income under the applicable REIT income tests (effective for tax years beginning after 2000); iv) adding an opportunity for a REIT to pay deficiency dividends for past year failures identified by the REIT (effective for tax years beginning after October 22, 2004); and v) providing a safe harbor for qualifying REIT sales of timber allowing such sales to avoid the prohibited transactions tax on dealer sales (effective for tax years beginning after October 22, 2004). I.R.C. §§ 856(c)(5)(G), 857(b)(7)(B), 856(d)(8)(A), 860(e)(4), and 857(b)(6)(D).

V. CONCLUSION

Notwithstanding these generally favorable changes, REIT tax compliance remains a technical and complex balancing act that must inform virtually everything a REIT does. The failure or violation of one of the myriad applicable tax rules can still lead to significant taxes and penalties. Nonetheless, these changes, to the extent some are retroactive, provide certainty to REITs for past tax years and, prospectively, generally improve the tax landscape for REIT operations and transactions. As a result of the AJCA, REITs now enjoy greater flexibility in how and what they invest in, increased prospects for foreign investment in the REIT, more certainty as to whether REIT operations will comply with tax rules, and less risk for inadvertent violations of those rules. These changes together should, on balance, enhance REITs' comparative attractiveness as real estate investment vehicles.

COBRA'S BITE: RETIREE MEDICAL BENEFITS IN A CHAPTER 11 BANKRUPTCY AND AFTER ACQUISITIONS

by Frank Tripodi, New York, NY

Unlike qualified pension benefits, welfare benefits do not vest automatically. Employee Retirement Income Security Act of 1974 ("ERISA") §201(1); *see also* Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995). Accordingly, an employer must typically perform some affirmative act, such as making an irrevocable promise to employees that such benefits are permanent in order for future benefits to become guaranteed. *See e.g.* In re Unisys Corp. Retiree Med. Benefit ERISA Litigation, 58 F.3d 896, 901 (3d Cir. 1995). Absent such action, an employer may reduce and/or eliminate prospective welfare benefits at virtually any time. Retiree medical benefits typically follow this general rule. However, employers who attempt to eliminate retiree medical benefits within one year before or after the filing of a Chapter 11 bankruptcy petition may find that section 4980B of the Code ("COBRA"), operates to vest this particular welfare benefit without any other affirmative act by the employer. Arguably then, the law permits employers to eliminate retiree medical benefits at anytime, unless the employer's business can no longer afford to provide such benefits. In addition, COBRA could make a purchaser liable for continuing coverage of former employees of a target even if the purchaser never employed those individuals itself.

COBRA

Generally, COBRA requires all employers who employed at least 20 employees in the preceding calendar year to offer continuing health coverage to an employee, the employee's spouse and/or dependent children (a "qualifying beneficiary"), who participate in the employer's group health plan if the employee or qualifying beneficiary loses coverage under the plan after a "qualifying event." I.R.C. § 4980B. A qualifying event occurs if the employee or a qualifying beneficiary loses health coverage as a result of: (a) the employee's death; (b) the employee's termination or reduction of hours; (c) the divorce of the employee from the employee's spouse; (d) the employee becoming eligible to receive Medicare benefits; (e) an employee's dependent child no longer qualifying under the terms of the plan; or (f) a substantial elimination of retiree health coverage occurring within one year before or after the commencement of a bankruptcy proceeding. I.R.C. § 4980B(f)(3)(A)-(F). The continuation coverage offered must be identical to the health coverage offered to similarly situated individuals that remain actively covered under the employer's health plan. I.R.C. § 4980B(f)(2)(A). If the employer alters or eliminates the health coverage provided to its remaining active employees, then the employer can amend the continuation coverage offered under COBRA. *Id.*

COBRA also mandates the period during which the health coverage must be offered to employees after a qualifying event. Regardless of the circumstance of the loss of coverage, an employer will no longer be obligated to offer continuation coverage if the employer does not maintain a health plan for its employees who have not undergone a qualifying event. I.R.C. § 4980B(e)(2)(B)(2). Additionally, COBRA does not require the employer to continue to offer continuation coverage to a participant who obtains coverage under another group health plan after a qualifying event. Treas. Reg. § 54.4980B-7, Q&A #2. If neither of these events occur in the interim, the maximum period of required continuation coverage under COBRA for non-bankruptcy related qualifying events is 18 to 36 months after such qualifying event,

with the most typical period of continuation coverage being 18 months. 4980B(f)(2)(B). However, if a participant loses coverage under a retiree medical plan within one year of the date a Chapter 11 bankruptcy petition is filed, then COBRA requires that the continuation coverage extend until the death of the participant, or for qualified beneficiaries, the date that is 36 months after the date of the death of the employee. I.R.C. § 4980B(f)(2)(B)(III). This lifetime provision of health care coverage under COBRA approximates the retiree coverage under the employer's health plan and cannot be terminated while the employer maintains a health plan for its active employees. COBRA effectively vests benefits that were intended to be discretionary.

Although the employer is not required to pay the full cost of such coverage, as COBRA permits employers to charge the employees for the coverage, there may still be high costs associated with the mandates of COBRA. The employer may charge as much as 102% of the cost of coverage for a participant who has not undergone a qualifying event (section 4980B(f) (2)(C)(i)), but this is typically not sufficient to cover the true cost of the coverage due to adverse selection. The cost of COBRA coverage is expensive for most individuals; accordingly, only the more unhealthy retirees or the higher consumers of health care will elect to purchase COBRA coverage. Healthier retirees might not elect continuation coverage. This limits the coverage pool and generally only the bad risks stay enrolled in the continuation coverage.

The retirees' choice in electing continuation coverage has a negative effect on the employer, regardless of whether the employer self-funds its welfare obligation or the employer purchases insurance to provide such benefits. If the employer self-funds its insurance obligations, each claim made by this group will be paid out of the general assets of the employer. Thus, each claim has a real cost for each dollar in claims paid that exceed the COBRA premium. Moreover, if the employer purchases insurance to meet these expenses, the employer will most likely have a bad experience rating, which will eventually raise the costs of insurance to the employer. Under COBRA, these increased costs cannot simply be passed on to those enrolled in continuation coverage and any such costs become vested expenses of the employer, even if the employer could have terminated the underlying welfare benefit at any time prior to bankruptcy.

COBRA AND CORPORATE TRANSACTIONS

The impact of COBRA is not limited to employers in bankruptcy. The COBRA rules could cause a subsequent employer to have to pay lifetime retiree medical benefits to workers that the subsequent employer never actually employed. An acquiror of a business that has terminated its retiree medical program in the context of a Chapter 11 bankruptcy will find that even structuring the transaction as an asset sale, which typically reduces the acquiror's potential liability for the debts of the target, may not be effective to avoid the target's liability under COBRA.

In 2001, Treasury finalized regulations (the "M&A Regulations") that addressed the responsibility for COBRA continuation coverage in the context of business transactions. Treas. Reg. § 54.4980B-9. Both in a stock sale and in an asset sale, the seller's controlled group is primarily liable to provide any required COBRA continuation coverage to participants whose qualifying event occurred prior to or in connection with the sale. Treas. Reg. § 54.4980B-9, Q&A 8(a). However, if the seller's controlled group eliminates its group health plan at any time after the sale or if the buyer purchases the entire controlled group of the seller, the buyer must provide the required COBRA continuation coverage to such participants, if the buyer is a "successor employer" under the M&A Regulations. *Id.* A buyer in a stock sale is virtually guaranteed to be a "successor employer." Treas. Reg. § 54.4980B-9, Q&A 8(b). A buyer in an asset sale will be a "successor employer," if the acquiror "continues the business operations associated with the assets purchased from the selling group without interruption or substantial change." Treas. Reg. § 54.4980B-9, Q&A 8(c). In fact, the M&A Regulations specifically provide that the buyer in an asset sale occurring in the context of a Chapter 11 bankruptcy will specifically be liable for the COBRA obligation of the bankrupt target if the buyer continues the business of the target. *Id.* This does not conform with typical common law notions of when a purchaser in an asset sale is a successor to the target. Although the seller and buyer may allocate liability for COBRA continuation coverage between the parties, if either party fails to perform as negotiated, the remaining party must perform as would have been required under the M&A Regulations in the absence of any such negotiation. Treas. Reg. § 54.4980B-9, Q&A 7. Thus, the lifetime COBRA obligation may transfer and become a liability of the acquiror, regardless of what form the transaction takes or of the parties' intent.

COBRA AND CORPORATE TRANSACTIONS SUMMARY

Due to the M&A Regulations, the buyer of a bankrupt entity may become responsible for providing lifetime COBRA coverage for the former employees of the target. Therefore, if any target in a potential transaction has been, or is currently, involved in a bankruptcy proceeding, focus should turn to the existence of a retiree medical plan. If such a plan is still in place, the parties could covenant that the target will not eliminate or "substantially reduce" such coverage within one year of the bankruptcy petition. If the target has already terminated its retiree medical plan, the acquiror must determine the cost of providing lifetime continuation coverage under COBRA to those who lost coverage within one year of the bankruptcy petition and account for such cost in any determination of the target's worth. Without taking these steps, the acquiror could be purchasing an unexpected lifelong liability. ■

POINT & COUNTERPOINT:

SHOULD THE INDIVIDUAL AMT BE REPEALED?

INTRODUCTION: The President's Advisory Panel on Federal Tax Reform has been charged with advising on options to make the Code "simpler, fairer, and more pro-growth." It does so as Congress considers a variety of tax-related topics, including funding for Social Security, making the 2001 and 2003 tax reductions permanent, and using a VAT to replace or supplement the federal income tax. Among the topics that the Panel and Congress may consider is the individual Alternative Minimum Tax (AMT), which was enacted in 1969 in response to reports of high-income taxpayers who paid little or no income tax. Over time, Congress expanded the AMT but failed to index its provisions. As a result, the AMT now affects a significant number of middle-class taxpayers and is often criticized. Although the Joint Committee on Taxation has called for repeal of the AMT, repealing the AMT will soon be more costly than repealing the income tax itself. In this Point/Counterpoint debate Professor Linda Beale of the University of Illinois makes the case for retaining the AMT with modifications, while Yoram Keinan of Ernst & Young argues that the AMT should just be repealed, the sooner the better. In reaching their conclusions each considers topics assigned to the Advisory Panel: simplicity, fairness, and growth. —*Gail L. Richmond, Fort Lauderdale, FL*

POINT: THE INDIVIDUAL AMT SHOULD NOT BE REPEALED (BUT SHOULD BE REFORMED)

by Linda M. Beale, Champaign, IL

Although the AMT was originally enacted to target the super-wealthy, various changes in the early years reflected Congress' goal of limiting the ability of any taxpayer to reduce his or her federal tax burden by aggregating preferences. The current AMT thus acts as a secondary tax system with flatter rate brackets and a broader tax base that applies whenever a taxpayer's accumulated preferences under the regular tax result in a tax liability below that demanded by the AMT. There are genuine concerns about its complexity, its potential reach into lower-income ranks, and its lessened effectiveness in ensuring that the wealthy pay at least a minimum level of tax on their economic income. Nevertheless, several factors outweigh these concerns. These factors include the country's current fiscal situation, efficiency arguments that recognize the AMT's reinforcement of policies underlying certain preferences, fairness arguments favoring the AMT as an existing mechanism for targeting high-income taxpayers in ways that remain politically palatable, and the potential for pragmatic reforms to ensure that the AMT retains its role as a supplemental rather than a primary tax system.

CURRENT FISCAL SITUATION

No discussion of potential AMT repeal can take place without considering the current fiscal context. Although the broadening reach of the AMT is undeniable, outright AMT repeal would even further burden ordinary taxpayers with future tax increases or spending reductions if 2001-2003 tax cuts are not substantially rolled back. Those tax cuts (including estate tax repeal) decreased progressivity and disproportionately benefited the super-rich. Fiscal pressures to reduce the federal deficit—more than $400 billion in 2004 and likely to soar to a record proportion of GDP in 2005 and beyond—hurt poorer Americans most, since programs that invest in human capital and welfare are targeted for reduction, but spending related to the United States' expanded global military presence and concerns about terrorist activity is not. Related increases in federal borrowing, at $7.6 trillion and rising, affect currency exchange, foreign trade and interest rates, with the greatest impact on prices of ordinary consumer goods and availability of credit for middle- and lower-income Americans. One study confirmed: "[o]nce the financing is included, the 2001 and 2003 'tax cuts' are best seen as net tax cuts for about 20-25 percent of households, financed by net tax increases or benefit reductions for the remaining 75-80 percent of households." William G. Gale, Peter R. Orszag, and Isaac Shapiro, *Distribution of the 2001 and 2003 Tax Cuts and Their Financing*, 103 Tax Notes 1539, 1539 (June 9, 2004).

EFFICIENCY REVISITED

Arguing from efficiency, critics suggest that it is counterproductive to step back preferences in the alternative system when those preferences operate as economic growth incentives in the regular system. Those arguments gloss over the polycentric and shifting rationales for preferences in the regular tax system—a provision that is proposed to reduce a surplus may be enacted to spur growth, or one that is originally enacted to spur growth may be retained even though it has been shown to have little or no effect on growth. Indirect reduction of subsidies *in the aggregate* through the AMT may be politically palatable when direct elimination of *particular* subsidies would not be possible.

Furthermore, if the AMT is retained but restructured so that ordinary taxpayers are exempt, the straightforward availability of preferences in the regular tax system, coupled with the limitations on preferences in the AMT system, can reinforce rather than undermine preferences that are designed to help ordinary taxpayers. For example, the mortgage

interest deduction was intended to allow ordinary Americans to realize their dream of owning a home. If they are assured of a mortgage interest deduction unaffected by the AMT clawback, the preference would encourage the purchase of modest homes as intended. At the same time, a change to the AMT treating all or part of the deduction as an AMT preference would appropriately lessen its incentive effect on the wealthy, since purchases of large homes (or purchases of second homes) would not be as likely to benefit. That result is not distortive of, but in fact consistent with, the original goal of the mortgage interest deduction to increase the percentage of Americans owning a home. The legislative history of AMT expansion reflects Congress' general understanding of this mechanism, noting the problem of wealthy taxpayers who benefit from provisions that were intended "to aid some limited segment of the economy." Committee on Ways and Means, *Report on the Tax Reform Act of 1969*, H.R. Rep. No. 91-413 (Aug. 2, 1969), at 1.

FAIRNESS DEMANDS

The recent changes to the overall federal tax system have significantly reduced its progressivity. The estate tax, a major redistributive mechanism, has been substantially reduced and may even be eliminated. The failure of Congress, in enacting the recent tax cuts, to limit major preference items that disproportionately benefit high-income taxpayers makes it even easier for them to avoid tax on their economic income during their lifetimes, unless the AMT is retained as a backstop.

Wealthy taxpayers, as noted, receive generous benefits from the mortgage interest deduction applicable to first and second homes. They also can afford to purchase luxury health care and take advantage of the tax deduction for medically necessary facilities, such as swimming pools, that are beyond the reach of most. This different response to incentives is heightened because the majority of lower-income taxpayers do not itemize and therefore cannot take many regular tax deductions that significantly reduce tax bills for the wealthy. Moreover, the recent tax changes have extended additional regular tax preferences, including lower rates on capital gains that disproportionately accrue to the super-rich and a new sales tax deduction that reduces the cost in low income-tax states of luxury consumer purchases such as yachts, diamonds, and designer appliances. Changes that provide tax-favored treatment of savings beyond the amount ordinary Americans can set aside may yet be implemented. Without some mechanism such as the AMT to re-balance the allocation of the tax burden, working Americans will bear the full cost of government, and wealthy Americans will essentially have a free ride.

The AMT provides such a mechanism, by recalculating the tax burden when the cumulative preferences under the regular tax reach a critical threshold. It does not reach every wealthy American who is not otherwise paying taxes at the highest regular tax rates, but it reaches a substantial number of the wealthiest Americans. Although without some reforms the AMT will extend into the $75,000 income bracket in 10 years, the average income is still substantially below that amount, so that the AMT, even without realistically possible structural reforms, still increases overall progressivity.

AMT critics suggest that fairness benefits are not sufficient to support the AMT, yet offer no realistic solution in the current political climate to halt the slide towards regressivity. Neither AMT repeal coupled with retention of the current regular tax nor retention of the current AMT coupled with repeal of the regular tax would satisfy distributive justice goals. The revenue cost of AMT repeal would require that the regular tax be restructured to eliminate most changes made in the last four years. Given the investment of the current Congress and Administration in those changes, reversal is highly unlikely in the near future. A possible alternative to AMT retention would be to install phase-outs on all regular tax preferences, but most commentators disfavor phase-outs in the regular tax system as a major source of complexity for all taxpayers. Furthermore, phase-outs require Congress to determine an income ceiling for benefits. If that ceiling is different for different types of benefits, complexity mushrooms; yet a single ceiling for every type of preference may be inappropriate. If ordinary taxpayers can be exempted from the AMT, the AMT may actually provide a means of removing complexity from the system applicable to ordinary taxpayers while permitting AMT liability to be based on the cumulative preferences utilized by each taxpayer.

APPROPRIATE REFORMS

A simple reform, suggested by the National Taxpayer Advocate and other commentators, could eliminate two of the most significant AMT concerns—the complexity of AMT determinations for ordinary taxpayers and the expanding AMT reach into middle-income brackets. By establishing an income threshold, indexed to inflation, that would eliminate AMT liability for those with approximately twice the national average income or less, most Americans would have no need to be informed about the AMT or to do any complex AMT calculations.

That reform must be paid for through tax increases elsewhere in the system or substantial reduction of programs. In order to ensure that the AMT remains targeted towards higher-income taxpayers, these changes should include treating additional deductions and exclusions typically enjoyed by wealthy taxpayers as AMT preferences and repealing the recent rate cuts for the highest regular tax brackets.

CONCLUSION

In the current political environment, fairness concerns strongly favor retention of the "back-up" AMT system to ensure that taxpayers who have substantial preferences incur at least some tax liability. Concerns about complexity and continuing encroachment on middle-income brackets can be addressed by simple reforms such as instituting a reasonable gross income threshold for AMT liability that is indexed for inflation. Revenues for these reforms can be raised by the

addition of new preferences tailored to ensure that the AMT targets high-income taxpayers who aggregate preferences to avoid taxation and by eliminating the regular tax rate cuts for taxpayers in the highest income brackets.

COUNTERPOINT: THE INDIVIDUAL AMT SHOULD BE REPEALED

by Yoram Keinan, Washington, DC

The minimum tax, the predecessor to the current AMT, was enacted in 1969 to prevent "higher income individuals from substantially eliminating income tax liability through the excessive use of preferences." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 7. Congress reiterated that objective when it replaced the minimum tax with the AMT in 1978 and when it strengthened and expanded the AMT in the Tax Reform Act of 1986. Thus, the AMT was expected to enhance horizontal and vertical equity. It could also make the income tax system more efficient by limiting the use of preferences. Although administrability and revenue were not primary concerns when the tax was first enacted, the pendulum has now shifted, so that there are now calls for retaining the AMT for revenue considerations, and the difficulties of administering the tax have become a major drawback. This essay explores the AMT from these policy perspectives and concludes that the AMT hardly serves the purpose that originally justified its enactment. It should therefore be repealed. While some commentators call for retaining the AMT while fixing its current flaws, as discussed below, it will more efficient to repeal the AMT and fix the current flaws in the regular income tax system.

REVENUE

Since the scope of the AMT has significantly expanded, AMT revenue has increased. In the near future, most of the revenue from the AMT will come from "ability to pay" preferences. A recent estimate provides that over the next ten years, the revenue loss from repealing the AMT could reach $800 billion. Dep't of the Treasury, *Fact Sheet: The Toll of Two Taxes: The Regular Individual Income Tax and the AMT*, (JS-1293)(April 2, 2004). Nevertheless, this loss could be significantly reduced if AMT repeal is combined with the imposition of phase-outs on preferences. In any event, the sooner the AMT is repealed, the lower the costs of repealing it will be.

EFFICIENCY/NEUTRALITY

Some commentators believe that a tax is efficient if it promotes economic growth. Congress uses the regular tax to achieve social and economic objectives by providing preferences, including investment incentives. Nevertheless, the Joint Committee on Taxation explained that such preferences "become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 432-433. Taxing such preferences (which is equal to limiting them if the AMT and regular tax rates are equal, as is almost the case today) frustrates the purpose for enacting them. Thus, to the extent that it limits the use of preferences whose purpose is to encourage economic growth, the AMT is inefficient.

By contrast, a tax is viewed as efficient (neutral) if it does not interfere with a taxpayer's economic behavior. A neutral tax, therefore, is one without preferences. Prior to enacting the AMT, Congress considered limiting the use of certain preferences as an alternative to imposing a separate tax. Ultimately, Congress chose to achieve its equity objective by imposing a second level of tax on the sum of such preferences over an exemption amount. Having separate systems allows Congress to retain various preferences within the regular tax system while ensuring that the AMT limits their use. Such a dual system is even less neutral than the limitation method originally proposed.

In a dual system, one must question what types of preferences ought to be taxed in order to create a more efficient system. Under an all-inclusive regime, a preference would be any deduction, credit or exemption that reduces tax liability. Such a regime would create a tax base free from preferences, so taxpayers pay tax on their economic income. Under a narrower approach, only preferences that violate neutrality in a taxpayer's decision-making (tax-motivated activities) ought to be taxed.

The AMT has never had a tax base that approximates true economic income, largely because the AMT is subject to the same political pressures as the regular tax. The AMT has always targeted only selected preferences. In other words, it has discouraged activities that give rise to preferences on a limited basis. The original preferences generally included items related to investment activities. Subjecting such preferences to the AMT caused taxpayers to change their investment behavior solely to avoid the AMT. Thus, even in its original form, the AMT was inefficient. Attempts in 1986 to move the AMT closer to its intended purpose, with the addition of the book income preference, basically failed. In conclusion, Congress ought to focus on how to make the regular income tax more efficient rather than trying to keep two parallel systems, each of which is inefficient.

EQUITY

A study conducted in the late 1960s revealed that in 1967, 155 individuals with income above $200,000 paid no income tax. *See* Hearings on the 1969 Economic Report of the President before the J. Comm., 91st Cong. 46 (Govt. Printing Office 1969). Congress reacted quickly to this perceived unfairness by enacting the minimum tax. Congress assumed that the percentage of taxpayers subject to the tax would increase as income increased, thereby creating a more equitable tax system. In 1970, Alan Schenk observed that "[t]he net effect of this new tax thus makes the entire tax structure more progressive." Alan

Schenk, *Minimum Tax for Tax Preferences*, 48 TAXES 201 (1970).

In 1986, Congress stated objective in strengthening and expanding the scope of the AMT continued to be equity: "[T]he minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS, 10-87, at 7.

Nevertheless, the term "minimum tax" implies that Congress did not intend to enhance progressivity significantly and expected only some minimum achievement. In fact, the AMT added very few wealthy taxpayers to the income tax payment pool. Despite its presence, some wealthy taxpayers continue not to pay tax, and many others pay insignificant amounts.

Additionally, the AMT's burden has shifted to middle-class taxpayers. This shift is attributable to: (i) the significant expansion of the AMT base; (ii) the failure to index the AMT exemption for inflation; and (iii) the recent reductions in regular income tax rates. Due to the latter two factors, the pattern of more middle-class taxpayers being subject to the AMT will continue. As to the AMT base expansion, the targeted preferences in 1969 included excess investment interest, accelerated depreciation on real property and personal property subject to a net lease, rapid amortization of certified pollution control facilities, the exercise of certain stock options, percentage depletion, and capital gains.

Congress has since expanded the AMT base to include such "ability to pay" amounts as personal exemptions, the standard deduction, and certain miscellaneous itemized deductions.

Additionally, several regular income tax credits, such as those for education, are limited to the difference between AMT and regular tax liability, the effect of which is to partially establish that such credits are subject to the AMT. Finally, some preferences, which in 1969 were available to wealthy people, are available today to middle-income taxpayers; stock options are an example of this phenomenon. In 1969, stock options were generally limited to high-level executives; since then, their use as a compensation tool has broadened considerably.

Clearly, Congress' intention in enacting the AMT was not to impose a surtax on the middle class. The preferences that trigger the AMT today do not correspond to its original objective for two reasons: (i) Congress expanded the scope of the targeted preferences significantly; and (ii) Congress did not anticipate that preferences originally available only to wealthy taxpayers would become available to more taxpayers.

To conclude, as the commentators observed, the AMT has changed from a "class tax" to a "mass tax." Leonard Burman, William Gale, Jeffrey Rohaly and Benjamin Harris, *The Individual AMT: Problems and Potential Solutions*, 55 NAT'L TAX J. 555 (2002). Daniel Shaviro has stated that despite this shift, "the AMT unmistakably increases the overall progressivity of the fiscal system." Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 TAX NOTES 1455, 1460-61 (May 28, 2001). He agrees, however, that in the long-run, repealing the AMT would not create a more regressive tax system. In my view, although the AMT still prevents certain taxpayers from paying no tax, that equitable feature is insufficient to justify retaining it. A major motivation for the original minimum tax was to remove the most visible form of inequity—wealthy taxpayers paying no tax. Now that the AMT has become a "mass tax," it has precisely the opposite effect. Instead of giving middle class taxpayers comfort that wealthy individuals cannot avoid paying their fair share of tax, it subjects them to a complex tax that they don't understand and perceive as unfair. It is true that the regular income tax system has become less progressive in recent years. In my view, however, this development further supports repealing the AMT and focusing on retaining progressivity in the regular income tax system.

ADMINISTRABILITY

A complex tax regime is undesirable because it creates "deadweight loss." The original minimum tax was relatively easy to calculate. Numerous structural changes, particularly the shift from a minimum tax to an "alternative" minimum tax, have resulted in a more complex calculation scheme. Simply stated, taxpayers are now required, in addition to calculating regular tax liability, to determine if they are subject to the AMT, to calculate their AMT liability (if applicable), to compare their regular tax and AMT liabilities, and to pay the greater amount.

Opponents of the AMT state that its complexity should be a predominant factor in determining whether to repeal it. The National Taxpayer Advocate identified complexity as the most serious problem affecting individual taxpayers today and continues to recommend AMT repeal. While the increasing use of tax software simplifies the AMT calculation for tax return purposes, AMT planning is very difficult for most individuals. Repealing the AMT, therefore, will promote simplicity in the tax system. In contrast, retaining the AMT and trying to fix its current flaws will result, in my view, in even more complexity. Finally, the President's call for simplicity in the tax system further signals that administrability will play a greater role in tax policy in the near future.

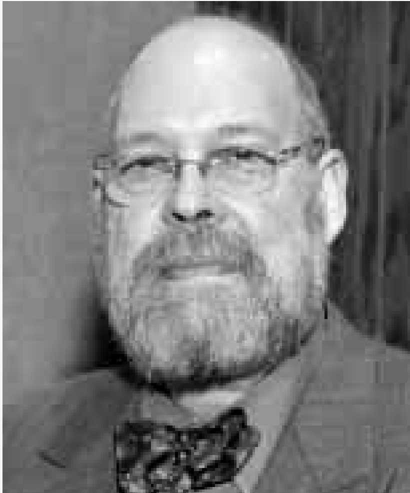
CONCLUSION

Ideally, taxable preferences ought to be preferences used primarily by wealthy people and preferences that arise from tax-motivated activities. A system that taxed such preferences would be equitable and efficient. Nevertheless, the current AMT base includes as preferences items not reasonably classified as tax-motivated and preferences that may be used by middle-class taxpayers. Thus, the current AMT is not only inefficient, it fails to serve its original equity objective. It also imposes enormous compliance costs. While eliminating the AMT would create a significant revenue loss, that should not prevent the repeal of the AMT. ■

INTERVIEW WITH
PROFESSOR MICHAEL J. GRAETZ

by Jasper L. Cummings, Jr., Raleigh, NC and Alan J.J. Swirski, Washington, DC

INTRODUCTION: Michael J. Graetz is Justus S. Hotchkiss Professor of Law at the Yale Law School. He served as Deputy Assistant Secretary of the Treasury for Tax Policy from 1990 to 1992. Professor Graetz has written a new book with Ian Shapiro entitled *Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth* published in March 2005 by Princeton University Press.



PROFESSOR MICHAEL J. GRAETZ

Q The estate tax affects only the richest two per cent of people in a country that prides itself on being the most democratic in the world. How did it become an object of such popular loathing?

A Repeal advocates managed to portray repeal as a righteous moral cause by presenting the tax as an unfair "double tax" on thrift and hard work. They also tapped into unbounded American optimism, appealing to the many people who believe either that they are going to get rich or that their children are. And repeal proponents took brilliant tactical advantage of the fact that no compelling moral arguments were made on the other side of the issue. Opponents of repeal failed to make any case for the moral unfairness of giving a huge, unearned, windfall benefit to the Paris Hiltons of this world. Had they done so, they might have argued that a failure to tax large inheritances undermines the American ideal of equality of opportunity. Instead they responded to moral arguments with math, attempting to move people with the observations that "only the richest two percent pay the tax" and "you won't pay it." This is a losing strategy in American politics.

Q You write that the movement to repeal the estate tax or "death tax" consists not of the super-connected super-rich, but largely of people who might not even be affected by it. Who exactly are these people and why did they work so hard to repeal it?

A They were largely small business owners and farmers, supplemented by people whose assets grew rapidly in the 1990s—dot-com millionaires, baby boom beneficiaries of the escalation in housing prices, and the like. The estate tax threshold of $1 million was low enough to cause them real concern. But they could easily have been taken care of by increasing the exemption to $3 to $5 million or so (double for a married couple) right away, as the repeal opponents eventually proposed. But by then it was too late; control of the movement had shifted inside the beltway, where ideological anti-tax activists, such as Grover Norquist, strongly preferred any version of total repeal, including this one, which is not achieved until 2010 and sunsets in 2011. This gives little, if any, security to many of those who pressed for repeal in the early and mid-1990s, though it may undermine the legitimacy of the tax—forcing proponents into the position of re-instituting it. Or so those who crafted the result in 2001 hoped. Notice that this gamble is more worthwhile the richer you are. For billionaires, an increase in the threshold to $3 or even $6 million is chump change; for them it's better to get a foot in the door for total repeal, hoping to make it permanent later. By contrast, for many farmers and small businessmen a $3 million or $6 million exemption is the whole enchilada. That tells you something about whose interests prevailed here.

Q In addition to your new book, "Death by a Thousand Cuts," you have written books attempting to explain federal taxes and social security to the general reader; for example, in 1997 you wrote "The Decline (and Fall?) of the Income Tax." Are you hopeful that the public will be able to make good choices about tax and social security issues?

A I am not impressed with the quality of public discourse about important public policy issues today. Most people do not read books like those that I have written. They rely instead on thirty-second commercials to make up their minds about complex financial issues. So while I am not terribly optimistic about the public's input on these issues, I do hope that there will be forums for more careful and complete debate.

Q Your 1997 and 1999 books discussed proposals to invest some part of FICA contributions in private accounts in the stock market. Do you endorse the President's current proposal that sounds somewhat similar, and why?

A I think private accounts have an important role to play in providing retirement security, particularly as the population ages. One of the key questions is what exactly will be the baseline social security benefit that will go along with these private accounts. So far, the President has not yet told us exactly what he has in mind. Until we know that, I am not sure anyone can answer this question confidently. In addition, there are many other issues awaiting answers in order to be comfortable with a private account proposal. For example, will these private accounts be converted into annuities at retirement, and if so will the annuities be inflation indexed? At the moment, the private market does not have a good mechanism for providing long-term inflation-indexed annuities. And insurance companies are now regulated by the states, not the Federal Government. Can we live with that if they are providing the annuities for private accounts? Issues like these seem important to me, and we will have to wait to see how the answers unfold.

Q Your books raise questions about the function of Treasury bonds that are held by the social security "trust fund". Would you explain whether or why the "lock-box" is a fiction and how early in the history of Social Security do you think the policy makers knew this?

A For a long time the Social Security system was essentially a pay-as-you-go system. There was no real accumulation of funds in the Social Security trust fund. Only after the 1983 revisions to Social Security was there any real effort to build up surpluses in the trust fund. And those surpluses are therefore a phenomenon of the past two decades. I think what we have learned during this period is that Congress is incapable of resisting using those funds to finance the general operations of the Federal Government. Therefore the surpluses are not contributing to additional national savings. Instead, they are simply keeping the overall federal deficits lower than they might otherwise be. This is one reason that I think that if we are going to have genuine pre-funding of social security, or a build up of national savings to finance social security benefits or retirement benefits over time, it is going to have to be done in the form of private accounts rather than in some government account, regardless of what the government account is invested in.

Q Your books suggested adopting a 10-15% VAT, excluding incomes below $100,000 from the income tax, and applying a flat 25% income tax rate to income over that amount. Do you still think that would work? Would you retain the FICA tax? Do you think adoption of a VAT is within the realm of political possibility in the near term?

A Yes, I do think it would work. In fact, it is one of the few major changes in our nation's tax system that offers a realistic prospect of real reform because it would be both revenue neutral and essentially distributionally neutral in the sense that it would not shift the tax burden down the income scale as would complete replacement of the income tax with either a flat tax or a national sales tax, as others have proposed. Here is what *The Economist* said a few months ago about this plan:

> Taken together Mr. Graetz's plans imply a wholesale change to America's tax system that may render them politically unrealistic. Nonetheless, the looming AMT crisis suggests that America has a rare opportunity to clean up its tax code. If he is really serious about reform, Mr. Bush should grasp it.

Unsurprisingly, I think *The Economist* got it just right. Your second question was about the FICA tax. I do retain the FICA tax although my plan includes a refund of FICA taxes as a way of protecting low and moderate income taxpayers from any tax increase due to the value added tax and also as a way of replacing the Earned Income Tax Credit. The great advantage of this plan is that it would relieve 150 million people from the burden of filing tax returns and would eliminate 100 million income tax returns that the IRS now receives. So this would be a major simplification of the existing system. And it also would be much more favorable to savings and economic growth than the existing system.

Q Consumption taxes, like the VAT, are usually said to promote savings, and therefore investment, which is thought to stimulate economic growth, resulting in the proverbial rising tide that raises all boats. What are your thoughts on that?

A The plan that I have proposed, which combines a consumption tax in the form of a value added tax with a much smaller income tax than we now have, is a system that would eliminate taxes on savings for most people and would reduce taxes on savings and investments for everyone. In that sense, it would be much more conducive to economic growth than the current system. The United States, in my view, has failed to take advantage of its unique position as a large developed country with a low tax burden relative to the size of its economy. If you look at the rest of the world, what you find is that our consumption taxes, which are now limited to only the state sales taxes and a handful of excise taxes on things like tobacco and gasoline, are much smaller than consumption taxes throughout the rest of the world. But our income tax is about the same size as those abroad, and, in fact, our income tax rates on investment (including the corporate rate) are higher than they are in many countries around the world. So by lowering the income tax rate to 25% and whittling the income tax down so it applies only to Americans with incomes over $100,000, my plan would put our consumption tax—both in terms of its rate and as percentage of the economy—in line with the rest of the OECD and make our income tax much smaller. I think all economists would agree that this kind of system would be much more favorable to long-term economic growth than the current system.

Q Did the comparison that you just made count the FICA taxes as a type of consumption tax and if not, why not?

A The FICA tax is a tax on wages, which makes it not quite an income tax and not quite a consumption tax. The other countries in the OECD also have wage taxes to fund their social insurance programs. And most of them have wage taxes at higher rates than ours. I leave the FICA tax off the table for two reasons: First, I think the wage tax works reasonably well, and, second, when you look at Social Security benefits along with the tax, we have a system that actually is reasonably progressive. The question of what, if anything, to do with FICA taxes—for example, whether the wage base should be raised—is a question that ought to be addressed in the context of Social Security solvency rather than in the context of tax reform, assuming that Congress is going to keep these two issues separate.

Q Are you troubled by a complete change to a consumption tax such as a VAT?

A Yes, I am troubled by the proposals to replace the income tax completely with a national retail sales tax or a flat-rate consumption tax. The reason is that both of these ideas would shift the tax burden away from people who are most able to pay down toward middle-income people who are less able to pay. My proposal maintains the progressivity of the existing system by having people with high incomes pay not only the consumption tax but also a relatively low-rate income tax.

Q What role do you believe the attacks Congress made on the IRS in the late 1990s played in the declining respect for the tax law you describe in your 1997 book?

A Some of the attacks on the IRS contributed to the public's declining respect for the income tax and fueled efforts by some politicians to "get rid of the IRS," which I regard as a fantasy. But I think that the decline in respect for the income tax is also grounded in a whole host of other events, many of which are more important. For example, I think that the rise in corporate tax shelters and the publicity about them has made people feel that high income individuals and well-advised corporations can readily avoid paying income tax and therefore, has made them wonder whether they are being foolish to pay the taxes that they owe. I also think that the overwhelming complexity of the income tax, so that no one can sit down and figure out exactly what they owe the government and why, is another major factor. Most people used to prepare and file their own returns. Today, commercial operations, like H&R Block or Jackson-Hewett, or computer programs, such as TurboTax, sit between individuals and their government when people file their returns. That, I think, diminishes not only people's respect for the tax but also their feelings of connection to their government. So I think that a large combination of factors has contributed to the decline in respect for the tax law. This decline is extremely pronounced if you look at attitudes from polling data among younger people, who are more and more willing to say that they do not feel any moral obligation to pay the government the taxes they owe. I believe this is one reason the current system is unsustainable and unstable, and why we need a major tax reform.

Q As Deputy Assistant Secretary for Tax Policy you were responsible for published guidance. Do you believe the Treasury's methodology for issuing published guidance works well, and if not how would you change it?

A I think Treasury took an important step in the right direction by creating a new deputy assistant secretary for regulations and appointing Eric Solomon to that post. This ensures that the Office of Tax Policy will always have its attention focused on getting regulations out the door even when legislative matters fully occupy the assistant secretary. The real problem, of course, is that Congress has been enacting legislation at a pace that makes it impossible for the IRS and Treasury to keep up. And typically new legislation multiplies complexities rather than eliminating them. When Congress, for example, insists that it matters where a company roasts coffee beans to know whether it qualifies for a domestic manufacturing tax break, the real surprise is that the guidance process works as well as it does.

Q You sit in a special place from the viewpoint of tax academia, with Boris Bittker and Marvin Chirelstein having gone before you (and both being still around). What is your view of the role of tax academics in the U.S. tax arena?

A Boris Bittker rightly became famous for his remarkable treatises, which synthesized and, with extraordinary grace and clarity, explained the law for generations of tax lawyers. Marvin Chirlestein's books on income taxation and contracts have performed a similar function for thousands of law students. Others of their generation—notably Harvard's Stanley Surrey and Virginia's Edwin Cohen—played important roles in formulating the nation's tax policy. While many academics today write books for students and seek to improve the law—Joe Bankman's recent efforts to create a return-free income tax for many California families is an important example—academics today rarely produce great treatises. There are several reasons for this, including the complexity of the tax law and the specialization of tax practice, as well as the fact that law faculties today do not value treatise writing as highly as they once did. So explaining the tax law now generally falls to practitioners. Tax law professors are primarily engaged in other forms of serious scholarship, which may be very important for understanding and improving the tax system, but which do not have a similar immediate pay-

off to the tax bar. This has resulted in a disconnect between the profession and the academy. The real challenge going forward is how to bridge this gap. That will require commitment and creativity from both sides.

Q Can you comment on the recent passing of David Bradford?

A David Bradford's tragic death is a great loss, not only for me personally, but for anyone interested in tax policy. I first met David nearly 30 years ago when he was at the Treasury working on what would become Blueprints for Tax Reform, which remains essential reading for anyone interested in a personal progressive tax on consumption. And David and I talked most recently only a few weeks before he died about various aspects of articles we were writing on tax reform. Throughout all the years I knew him, David was among the most honest, serious, talented and thoughtful public finance economists I have ever met. He was genuinely interested in the law, wanting to know how things really work in practice. He was always open to new ideas and remarkably generous in sharing both his time and expertise. He was also a very good listener. David was a mensch; he will be sorely missed. ■

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SPOTLIGHT ON COMMITTEES: COMMITTEE ON VALUE ADDED TAX AND OTHER CONSUMPTION TAXES

by Alan Schenk, Detroit, MI, Victoria Perry, Washington, DC, and Reuven Avi-Yonah, Ann Arbor, MI

In 1970, President Nixon considered the possible introduction of a value added tax, with the revenue to be rebated to the states that replaced part or all of their property tax used to finance education. Reportedly, President Nixon was advised that he could not propose a VAT at that time because the tax was unfamiliar to the tax professionals and the public. In 1971, the Section of Taxation appointed a special committee to study the VAT. The special committee later was converted to the Committee on Value Added Tax and then renamed the Committee on Value Added Tax and Other Consumption Taxes to reflect the fact that our charge went beyond VAT to other consumption taxes that were being proposed at the federal level.

Although the U.S. does not have a VAT, nearly all other countries of the world do, and VAT therefore constitutes an important part of the tax burden borne and the tax planning undertaken by major clients of many members of the Section. While U.S. lawyers would normally engage local counsel in tax planning in other jurisdictions, some basic knowledge of the subject, including trends and current issues, is nonetheless important.

For the past 34 years, the Committee served as the only Section committee with expertise in VATs and other proposed federal taxes on consumption. Our Committee has been used as the resource to educate Section members and to respond to Congressional and other proposals for a broad-based federal tax on consumption. The core, long-standing members of the Committee have published numerous books and articles dealing with VATs and other consumption taxes, and have experience assisting developing and emerging market countries in drafting national and subnational VATs, and organizing the implementation and administration of those VATs. Some members have first-hand experience complying with foreign VATs and serving as experts in international arbitrations involving VAT.

The Committee has published four articles in the Tax Lawyer, starting in 1972. In addition, in 1989, it developed a model VAT for the U.S. that was accepted by the Council of the Section. In drafting the model VAT, the Committee started with the European-style, credit-invoice VAT bill introduced by House Ways and Means chairman Al Ullman in 1979 and again in 1980. This model was introduced in Congress in 1991 and again in 1995 by Senator Hollings. The Hollings VAT was designed to raise revenue to finance either deficit reduction or national health care, or both.

When Senator Roth proposed the Business Transfer Tax in 1985, the Committee prepared an analysis of this VAT, which relied on company records, unlike the European VAT, which relies on invoices and is based on transactions. The Committee has presented a mini program on VAT and discussed VAT at a plenary session of the Section. Before the Committee's charge was expanded to include other consumption taxes, the Committee was part of a Section task force in 1996 to examine a myriad of consumption tax proposals introduced in that session of Congress. The Committee also developed a set of consumption tax principles that can be used in the development of a federal tax on consumption. These principles were adopted by the Section at a plenary session in January, 2000. We have presented several programs with foreign VAT experts and members of our Committee, at the invitation of Congressional committees, have testified on fundamental tax reform, including the role of VAT and other consumption taxes.

In the past several years, there have been a number of dramatic (even radical) tax proposals by members of Congress and others to shift from our reliance on taxes based on income to taxes based on consumption. They include the adoption of a federal VAT or other broad-based tax on consumption to replace some or all existing federal taxes. In the 108th Congress alone, the following proposals were introduced:

1. Representative John Linder's National Sales Tax (a retail sales tax) (H.R. 25 Fair Tax Act of 2003).
2. Representative Nick Smith's Flat Tax (H.R. 3060 Tax Simplification Act of 2003).
3. Senator Phil English's Simplified USA Tax Act of 2003 (H.R. 269) – like the two-part USA Tax Act of 1995 introduced by Senators Nunn and Dominici.
4. Representative John Dingell's Credit-Invoice VAT (H.R. 15 National Health Insurance Act of 2003) to finance national health care.

In addition, Professor Michael Graetz proposed the removal of 100 million taxpayers from the income tax rolls, with the lost revenue to be recouped with a European-style VAT. Another round of intense discussions of this subject may begin when the commission examining the federal tax system reports to the Secretary of the Treasury in mid-2005.

Whether our tax practices are limited to American clients or include businesses engaged in international operations, it is imperative that we learn about VAT and other proposed federal taxes on consumption. Increasingly, American lawyers are not able adequately to advise their clients in drafting contracts or planning international transactions without a basic understanding of these taxes. In addition, we may be called upon by our clients to examine the impact of a U.S. VAT or other consumption tax on them.

The Committee will keep the Section informed about developments in this area, with mini-programs and analyses of new proposals for a federal tax on consumption. We invite other Section members to join our Committee. ■

PRO BONO UPDATE:
2005 PRO BONO AWARD RECIPIENT DIANA LEYDEN

by Pamela F. Olson, Washington, DC

DIANA LEYDEN

Each year, the Tax Section presents a Pro Bono Award to someone who has devoted time and energy to pro bono representation, particularly representation of low-income taxpayers.

This year the award is presented to a member who has excelled in her personal efforts on behalf of low income taxpayers and has inspired the efforts of those around her.

Our award winner has chaired the Tax Section's Low Income Taxpayer Committee, and teaches not one, but two sections of a low income taxpayer clinic at her law school, doubling the number of students able to participate, increasing the number of individuals who can be assisted by the clinic, and ensuring continuity of care for those who are.

When her locale was identified for an EITC pilot effort by the IRS, she provided organization and assistance to community leaders, developed materials to navigate the issues, and provided a web-based assistance program in English *and* Spanish.

Our award winner practices holistic lawyering for her low income clients. She helped create a coalition ("Take Your Money Connecticut") of local community groups—social, non-profit, government, and business—that provides financial education together with free tax return preparation.

Our award winner was nominated by her students, to whom she has taught holistic lawyering. Her students refer to their memos as having been "Dianatized" when her holistic comments pepper their work product.

Finally, our award winner's students have particularly noted her high ethical standards and the time and effort she devotes to imbuing in them those same high ethical standards.

For all of these reasons, Diana Leyden is this year's recipient of the American Bar Association Section of Taxation's Pro Bono Award.

Please join me in congratulating Diana Leyden. ■

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GOVERNMENT SUBMISSIONS BOXSCORE

Since January 1, 2005, the Tax Section has coordinated the following government submissions, which can be viewed and downloaded free of charge from the Section's website at www.abanet.org/tax/pubpolicy.

COMMENTS ON REGULATIONS AND ADMINISTRATIVE RULINGS — WINTER 2005* SUBMISSIONS TO U.S. TREASURY DEPT. & IRS

I.R.C. §	DATE	TITLE	COMMITTEE	CONTACT
various	4/6/05	Proposed Treasury Regulation Section 1.752-2	Partnerships and LLCs	Todd Molz
409A	3/28/05	Definition of Nonqualified Deferred Compensation Focusing on Foreign Plan Issues	Employee Benefits	Wayne Luepker; Susan Serota
n/a	2/17/05	Announcement 2004-98 — Comments Regarding the Advance Pricing Agreement	Transfer Pricing	Darrin Litsky
6111, 6112, 6708	2/7/05	Notice 2004-80 (Interim Guidance Under IRC §§ 6111, 6112, and 6708)	Administrative Practice; Partnerships and LLCs; Standards of Tax Practice; Tax Shelters Task Force	Paul Carman
368	2/7/05	Transfers of Assets and Stock Following a Reorganization	Corporate Tax	Philip Levine; Darin Zywan
6111, 6112, 6708	1/26/05	Interim Guidance Regarding Disclosures by Material Advisors (Notice 2004-80)	Administrative Practice; Tax Shelters Task Force	Armando Gomez

*The comments listed in this index represent the individual views of the ABA Section of Taxation members who prepared them. They have not been approved by the Section of Taxation, the House of Delegates or the Board of Governors of the ABA and do not represent the position of the Association or of the Section.

CLE CALENDAR

All programs subject to rescheduling or cancellation. For the latest information, refer to the contacts listed below.

DATE	PROGRAM	CONTACT
May 25, 2005 1-2:30pm ET	**"Last Wednesday" Teleconference Series:** Proposed Regulations on Insolvent Corporate Reorganizations, Tax-Free Liquidations, and Tax-Free Incorporations—What You Need to Know	ABA Tax Section www.abanet.org/tax 202-662-8670
June 2-3, 2005	**Third Annual International Tax Institute**—Planning for US Multinationals in the Current Global Tax Climate, Fordham University School of Law, New York, NY	ABA Tax Section www.abanet.org/tax 202-662-8670
June 9-10, 2005	**Charitable Giving Techniques** Hotel Monaco, Seattle, WA	ALI-ABA www.ali-aba.org 800-253-6397
June 29, 2005 1-2:30pm ET	**"Last Wednesday" Teleconference Series:** Exempt Organizations Topic TBA	ABA Tax Section www.abanet.org/tax 202-662-8670
July 13-15, 2005	**Estate Planning for the Family Business Owner** Ritz Carlton, Boston, MA	ALI-ABA www.ali-aba.org 800-253-6397

SECTION MEETING CALENDAR

2005	**MAY MEETING**, **May 19-21**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **September 15-17**, Park Hyatt & Hyatt Regency, San Francisco, CA
2006	**MIDYEAR MEETING**, **January 19-21**, Sheraton Center, New Orleans, LA
	MAY MEETING, **May 4-6**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **October 19-21**, Hyatt Regency, Denver, CO NEW
2007	**MIDYEAR MEETING**, **January 18-20**, Westin Diplomat, Hollywood, FL
	MAY MEETING, **May 10-12**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **September 27-29**, Hyatt Regency and Fairmont, Vancouver, BC

NEWS **BRIEFS**

2005 NOLAN FELLOWS HONORED

The Section honored the recipients of its 2005 Nolan Fellows awards in January during a luncheon at the Section's Midyear Meeting in San Diego. Nolan Fellows are younger tax lawyers who are actively involved in the Section and have demonstrated leadership qualities.

The six 2005 Nolan Fellows are:

- **Arlene Suzanne Fitzpatrick**, Ernst & Young LLP, Washington, D.C.
- **Peter A. Furchi**, Debovoise & Plimpton, LLP, New York, New York
- **Gregory J. Gawlik**, Thompson Hine, Cleveland, Ohio
- **Brant Hellwig**, Associate Professor of Law, University of South Carolina School of Law
- **Michael M. Lloyd**, Miller & Chevalier Chartered, Washington, D.C.
- **Jeanne Newlon**, Venable, Baetjer, Howard & Civiletti, LLP, Washington, D.C.

Each one-year fellowship includes the waiver of Meeting registration fees and assistance with travel to some Section meetings. For more information about the 2005 Nolan Fellows program visit the Section's website, www.abanet.org/tax.

YLF ANNOUNCES TAX **CHALLENGE WINNERS**

The Section's Young Lawyers Forum is pleased to announce the winners of the **2004 Law Student Tax Challenge (LSTC)**.

The **1st Place Team** was Brian Judkins and Dan McCall of the Georgetown University Law Center. Their winning submission is available on the website at http://www.abanet.org/tax/lstc/home.html.

The **2nd Place Team** was Kevin Morriss and Jason Rednour, of the Chapman University School of Law.

The **3rd Place Team** was Atim Nsunwaaq and Soyun Park, of the Georgetown University Law Center.

The **Best Written Submission** was by the first-place team, Brian Judkins and Dan McCall of the Georgetown University Law Center.

The LSTC is a national tax planning and client-counseling competition designed to more closely reflect everyday tax practice than traditional moot court competitions. The LSTC is now in its fourth year and has become one of the largest tax competitions for law students in the United States. The semi-final and final rounds of the 2004 LSTC took place in January, 2005, in San Diego, California, during the Section of Taxation Midyear Meeting. For more information, visit the LSTC website at http://www.abanet.org/tax/lstc/home.html.

STATE AND LOCAL TAX LAWYER **ARTICLES ONLINE**

You may now purchase and download individual articles from THE STATE AND LOCAL TAX LAWYER, the Tax Section's premier journal on current issues and trends in state and local taxation, through the ABA webstore. Articles from the 2002 through 2004 editions are available, with more to come. For a complete list, visit the ABA webstore at www.ababooks.org and search the publication title under *e-products*.

SECTION MEETING **AUDIO CDS AND TAPES AVAILABLE**

Teach'em, the Section's traditional provider of recorded Section Meeting programs is now offering recorded sessions in both audiotape and CD-ROM formats. To order, visit the **Teach'em** website at www.teachem.net/aba.

TAX TIPS 4 U: **EDUCATION TAX BENEFITS**

In conjunction with this year's tax season, **TaxTips4U.org**, the Section's public outreach website, recently added information about higher education tax benefits. **TaxTips4U.org** is designed to provide information to consumers seeking a better understanding of their rights and responsibilities as taxpayers, and the new higher education benefits menu includes helpful information about the variety of exclusions, credits, and deductions available, as well as links to key federal government reports and websites.

DEBT COLLECTION WORKSHOP IN MAY

This year's May Meeting includes a special half-day workshop designed as a practical skills session for attorneys on the issue of collections. The **"Collection of Federal Tax Debt"** workshop, co-sponsored by the Section's Low Income Taxpayer and Pro Bono Committees, will be held Thursday, May 19, from 1:00 p.m. – 5:30 p.m., at the Grand Hyatt in Washington, DC, followed by a reception sponsored by Skadden Arps. ■

TAX BITES GOES HOLLYWOOD!

Compiled by Gail Levin Richmond, Fort Lauderdale, FL

Taxpayers from all walks of life have tax problems. But when the rich and famous encounter an IRS deficiency notice, the world takes note. And why not? Celebrity-watching and tax-paying are "enjoyed" by a substantial percentage of our population. Perhaps it's time for to offer a soap opera or reality show devoted to those encounters.

Possible titles, suggested by Interview Editor Alan Swirski, appear below. Now it's up to our readers. Using one of the titles below (or one you create yourself), write a one-paragraph concept paper. Bonus credit will be awarded for clever casting suggestions. Future columns will publish particularly clever responses. ■

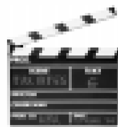
The Twilight Zone of Tax
ANOTHER DIMENSION

Dictated But Not Taxed
PRIVILEGED AND CONFIDENTIAL
(contributed by B. John Williams)

Tax Times Two
READING BETWEEN THE LINES

Taxing the Unknowable
WHAT DO YOU THINK?

To Tax or Not To Tax
I'LL KNOW IT WHEN I TAX IT



Tax at the Edges
THE EDGE OF TAX

Tax Time Out
BREADTH AND TAXES

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